2006

HERITAGE OIL CORPORATION

2006 Annual Report

HERITAGE
Oil Corporation

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ON THE COVER

The Pied Kingfisher (Ceryle rudis), commonly sighted over Lake Albert, Uganda

Photograph courtesy of Dave Behrens

FINANCIAL CALENDAR 2007 *

May 15: First quarter results
June 21: Annual General Meeting
August 14: Second quarter results
November 14: Third quarter results
Heritage is listed on the Toronto Stock Exchange under the symbol HOC.
For updated share prices see www.heritageoilcorp.com.
*Subject to possible changes

ANNUAL GENERAL MEETING

The annual meeting of shareholders of Heritage will be held June 21, 2007 at 3 p.m. in the Cardium Room of the Calgary Petroleum Club.

Shareholders are encouraged to attend the meeting, but those who are unable to do so are requested to sign and return the form of proxy.

COMPANY PROFILE

Heritage Oil Corporation is a Canadian-based independent, international oil and gas exploration, development and production company. The Company has exploration projects in the Republic of Uganda and the Democratic Republic of Congo, a producing property in the Sultanate of Oman, a development property in Russia and is pursuing opportunities in the Kurdistan region of Iraq and other areas in Iraq.

The Company's producing, development and exploration projects, together with potential opportunities, provide a combination of early cash flow and longer term value creation opportunities.

The Company's shares trade on the Toronto Stock Exchange (TSX), under the symbol HOC.

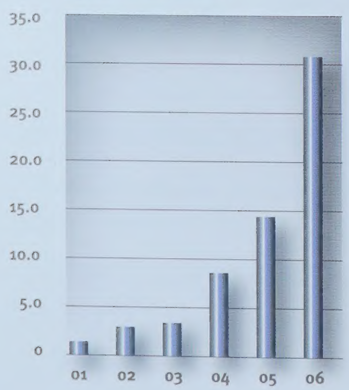
FORWARD-LOOKING INFORMATION

Except for statements of historical fact, all statements in this document – including, without limitation, statements regarding production estimates and future plans and objectives of Heritage – are forward-looking statements that involve various risks and uncertainties. There can be no assurance that such statements will prove to be accurate; actual results and future events could differ materially from those anticipated in such statements. Factors that could cause actual results to differ materially from anticipated results include risks and uncertainties such as: risks relating to estimates of reserves and recoveries; production and operating cost assumptions; development risks and costs; the risk of commodity price fluctuations; political and regulatory risks; and other risks and uncertainties as disclosed under the heading "Risk Factors" in the AIF and elsewhere in Heritage documents filed from time-to-time with the Toronto Stock Exchange and other regulatory authorities. Further, any forward-looking statement is made only as of a certain date and the Company undertakes no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or reflect the occurrence of unanticipated events, except as may be required by applicable securities laws. New factors emerge from time to time, and it is not possible for management of the Company to predict all of these factors and to assess in advance the impact of each such factor on the Company's business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement.

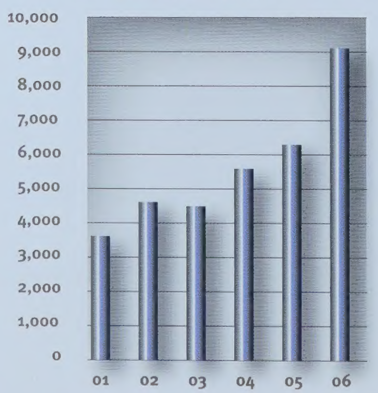
FINANCIAL AND OPERATIONAL HIGHLIGHTS

United States Dollars	2006	2005	2004	2003
Petroleum and natural gas revenue from continuing operations	**3,938,512**	841,766	3,288,348	1,680,527
Total petroleum and natural gas revenue	**9,054,880**	6,286,702	5,592,721	4,517,108
Gain on sale of discontinued operations	**9,950,968**	-	26,269,113	-
Net earnings (loss)	**1,336,332**	(3,799,813)	28,364,368	2,566,564
Per share (basic)	**0.06**	(0.18)	1.33	0.13
Per share (diluted)	**0.06**	(0.18)	1.31	0.12
Total assets	**160,427,455**	86,254,378	80,619,246	48,099,499
Total capital expenditures	**42,845,579**	20,554,465	37,318,136	7,065,603
Convertible bonds	**57,115,731**	-	-	-
Debt	**8,557,513**	7,768,483	-	-
Shareholders' equity	**79,629,903**	71,265,792	73,893,446	44,913,585
Production (bpd)				
Oman	**169**	140	218	267
Congo (discontinued operations)	**217**	318	195	274
Proved + Probable Reserves (mmboe)	**69.5**	71.6	13.9	18.0
Closing share price (Cdn$)	**30.75**	14.45	8.65	3.40

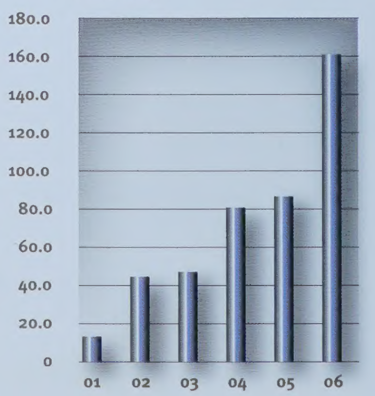
YEAR-END SHARE PRICE (CDN$ PER SHARE)



PETROLEUM AND NATURAL GAS REVENUE (US$M)



TOTAL ASSETS (US$MM)



LETTER TO SHAREHOLDERS

Dear Shareholders,

It is a pleasure to report on Heritage's remarkable 2006. Events include substantial discoveries in Uganda and Oman, the signing of a Production Sharing Agreement (PSA) in the Democratic Republic of Congo, completion of non-core asset sales for aggregate cash proceeds of over US$27 million, a fundraising and commencement of a multi-well drilling program in the West Chumpass field, Russia. With the recent completion of a US$165 million financing, we are well positioned to advance exploration and development programs in all our core areas.

UGANDA

Last year produced many important milestones in Uganda after nine years of effort, the principal being the significant discovery in Block 3A, Uganda (Heritage operator, 50% interest). Our Kingfisher deviated well was drilled to a total depth of 3,195 metres, which was close to the limit of the rig's operational capability, however, our primary target lies beneath 3,200 metres and thus could not be reached. Four intervals were tested successfully, producing an aggregate flow rate of 13,893 bopd through a one inch choke. The oil is good quality light (30° to 32° API), sweet oil with a low gas-oil ratio and some associated wax. The reservoirs are sandstones with high permeability of up to 3,000 milliDarcies.

The Kingfisher success proves there is a working hydrocarbon system in the Albert Basin. Under our accelerated 2007 work program, two seismic surveys will be shot; an approximately 325 square kilometre 3D program over the Kingfisher and Pelican structures in Block 3A and an approximately 500 kilometre 2D survey in Block 1. Further drilling of the Kingfisher prospect will commence following the acquisition and interpretation of the 3D seismic survey and will target the primary objective that could not be reached with the previous rig. Efforts are currently being made to identify and secure a higher capacity rig, capable of deeper drilling, to explore the deepest objectives in the Albert Basin towards the end of 2007. Drilling of the Pelican structure is expected to commence in 2008.

In the last 15 months all five wells drilled in the Albert Basin (one on our Block 3A and four in Block 2 owned by Tullow Oil) have discovered oil and two test produced over 12,000 bopd. This is a remarkable record for a virgin onshore hydrocarbon basin.

DEMOCRATIC REPUBLIC OF CONGO

Heritage signed a PSA in the Democratic Republic of Congo (DRC) in the summer of 2006 for a 39.5%, non-operated interest in Blocks I and II. This area covers over 6,000 square kilometres of onshore and offshore acreage in the DRC part of the Albert Basin that extends into neighbouring Uganda. When combined with our two licenses in Uganda, the gross land position in the Albert Basin is over 12,000 sq km.

RUSSIA

During 2006, we made considerable progress in the development of our 95% owned West Chumpass field concession in West Siberia. A 200 km 2D seismic survey was acquired, civil works were undertaken, an operating office was established in Nizhnevartovsk and the existing well #226 was re-entered culminating in a preliminary free-flow test that produced 124 barrels of oil over a five hour period. This corresponds to approximately 600 bopd. A multi-well drilling program commenced in April 2007, targeting the same reservoir as well #226.

LETTER TO SHAREHOLDERS

A significant step for Heritage was the signing in 2006 of an agreement with TISE Holding Company to establish a jointly-owned company, TISE HERITAGE NEFTEGAS, to appraise and acquire oil and gas opportunities in Russia and internationally. The profile, strength and stature of TISE and its shareholders ensures Heritage's operations in Russia will continue to be undertaken in an efficient and transparent manner.

OMAN

In Oman, the Company was party to the very substantial success in the drilling of the West Bukha-2 appraisal/development well in Block 8 in Oman (10% interest, non-operated). This well test produced a combined flow-rate from two zones of approximately 12,750 bopd and 26 MMscf/d of gas. Field development is on-going with production from the West Bukha field slated to commence in the first half of 2008.

KURDISTAN REGION OF IRAQ

Heritage continues to focus on the Kurdistan Region of Iraq as the security situation in this region allows oil and gas companies to start exploration activities. We have maintained a presence in the country since opening an office in Erbil in August 2005, and in 2006 we undertook field geological and geophysical surveys. Subsequent to year-end, we submitted an application for a PSA to the Minister of Hydrocarbons of Kurdistan. The draft oil and gas law, prepared by the Council of Ministers and the Oil and Energy Committee, has been sent to the Iraqi Parliament for approval, and it is anticipated that ratification of our PSA may be obtained during the summer of 2007, after Parliament approval of the new law.

ASSET DISPOSITIONS

During 2006 Heritage completed a two stage sale of its interests in the Republic of Congo (Congo) which generated sales proceeds of over US$27 million and a one-off gain of US$9,950,968. In November 2006, the sale of Heritage Congo Limited, which held a 14% working interest in the Noumbi Exploration Permit, was completed for US$21,000,000 of cash and 1,500,000 Afren warrants, with a term of five years and an exercise price of £0.60 GBP Sterling per share.

In January 2007, we finalized the statement of adjustments relating to the sale of a 25% working interest in the Kouakouala A license and a 30% working interest in the Kouakouala B license for US$6,052,515 of cash and an overriding royalty of 15% over a 30% working interest in the Kouakouala B license in relation to the Mengo Field.

OUTLOOK FOR 2007

Heritage will focus on the following goals in the coming year:

- Substantial increases in production from the West Chumpass field. The multi-well drilling program, which commenced in April 2007, should materially change future reported production and financial performance.
- Completion of two seismic surveys in Uganda, the spudding of the Kingfisher-2 well and preparation for drilling of the Pelican structure.
- Commencement of an exploration program on Blocks I and II in the DRC following receipt of the Presidential Decree ratifying the PSA.
- Continued development of the West Bukha field in Oman to ensure production commences in the first half of 2008.
- License award in the Kurdistan Region of Iraq and commencement of an exploration program in the license area.

As always, we and the rest of the Board of Directors are very grateful to our employees and investors for their dedication and contribution to the remarkable growth Heritage has enjoyed this past year. Shares of Heritage closed at Cdn$30.75 at the year-end, 113% higher than at the start of the year and we have since reached a new high of Cdn$40.00. We continue to believe that shareholders should expect the Company to achieve material increases in operating and financial performance. To this end, we are continuing to actively negotiate with a number of governments and entities in our core areas (the Middle East, Russia and Africa) to acquire additional attractive assets that have the potential to increase the Company's reserve base and production rate. To complement this effort, while ensuring active ongoing resources are provided for our expanding operational profile, we raised US$165 million of five year convertible 8% bonds with J.P. Morgan Securities Ltd. in February 2007. These bonds have an exercise price of US$47.00 per share. US$82,500,000 of the proceeds were used to finance the redemption of outstanding convertible bonds with remaining proceeds available to fund 2007 programs.

While we can assure you we are delighted with the achievements reported in 2006, we are diligently working to expand on this success in coming years.

Tony Buckingham

Chief Executive Officer

May 3, 2007

Michael J. Hibberd

Chairman

RESERVES

The Company's year-end reserve evaluation (the RPS Energy Report) effective December 31, 2006 was prepared by RPS Energy Canada Limited, trading as RPS Energy (RPS Energy), an independent geosciences consultancy that is owned by RPS Group plc.

The Company has total proved plus probable reserves of 69.5 Mmboe as at December 31, 2006, a decrease of 2.1 Mmboe from the 2005 year-end estimate by RPS Energy. This reduction is wholly attributable to the sale of the interests in the Republic of Congo in 2006 and the decision to relinquish Block 17 in Oman, which included the Tibat discovery. Management notes that the 2006 year-end estimates did not include reserves for the Company's interest in the West Bukha field, Oman, since there was not sufficient time to evaluate the project following completion of the test program in January 2007.

Proved plus probable reserves have an estimated value of US$253.6 million at December 31, 2006, assuming forecast prices and a discount rate of 10%. If the Congo interests are excluded from the 2005 year-end value, the estimated value of proved plus probable reserves increased by 5%.

Estimated proved and probable reserves net to the Company, together with the estimate value, assuming forecast prices and a discount rate of 10%, may be summarised as follows:

Reserve Category	Area	Reserves (Mmboe)	NPV discounted at 10% (US$Mm)
Proved	Russia	23.09	10.04
	Oman	0.19	2.68
Total Proved		23.28	12.72
Additional Probable	Russia	46.16	240.34
	Oman	0.06	0.52
Total Proved Undeveloped		46.22	240.86
Total Proved plus Probable		69.50	253.58

Pricings used in the RPS Energy Report with respect to values of future revenue (forecast) as well as the inflation rates used for operating and capital costs are set forth below.

		Oman							Russia	
		Condensate		Saudi Export		Bukha				
Year	Brent $/bbl	NWS $/bbl	Bukha $/bbl	Propane $/tonne	Butane $/tonne	Propane $/tonne	Butane $/tonne	Urals Export Blend $/bbl	Domestic $/bbl
2007	57.99	56.77	54.07	470.36	476.89	376.29	381.51	53.84	27.16
2008	60.37	59.02	56.32	483.21	489.44	386.57	391.55	56.02	28.28
2009	58.88	57.60	54.90	475.14	481.55	380.11	385.24	54.65	27.58
2010	56.87	55.70	53.00	464.33	470.99	371.46	376.79	52.81	26.64
2011	55.08	54.01	51.31	454.71	461.59	363.77	369.27	51.17	25.80
2012	54.75	53.70	51.00	452.91	459.84	362.33	367.87	50.86	25.65
2013	54.38	53.35	50.65	450.92	457.89	360.74	366.31	50.52	25.47
2014	55.47	54.38	51.68	456.78	463.62	365.43	370.90	51.52	25.98
2015+	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa

The following cautionary statements are specifically required by NI 51-101 and apply to each of the following tables.

1. Estimates of future net revenue used in calculating discounted and undiscounted net present values (NPV) do not represent fair market value.

2. Due to the effects of aggregation, estimates of reserves and future net revenues for individual properties may not reflect the same confidence level as estimates of reserves and future net revenues for all properties.

3. A BOE conversion ratio of six mcf to one barrel of oil has been used. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of six mcf to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

4. The aggregate of exploration and development costs incurred in the most recent financial year and the change during that year in estimated future development costs generally will not reflect total finding and development costs related to reserves additions for that year.

The following table, based on the RPS Energy Report, summarizes the net oil, NGLs and natural gas reserves attributable to oil and natural gas interests of Heritage as at December 31, 2006. It should not be assumed that the discounted future net production revenues estimated by the RPS Energy Report represent the fair market value of the reserves. Other assumptions and qualifications relating to costs, prices for future production and other matters are included in the RPS Energy Report. There is no assurance that the future price and cost assumptions used in the RPS Energy Report will prove accurate and variances could be material.

	Light and Medium Crude Oil (Mmbbl)		Gas (Bcf)		Oman-NGLS (Mmbbl)		Oil Equivalent (Mmboe)	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Proved Producing	–	–	2.96	–	0.31	0.19	0.80	0.19
Proved Undeveloped	23.09	23.09	–	–	–	–	23.09	23.09
Total Proved	23.09	23.09	2.96	–	0.31	0.19	23.89	23.28
Additional Probable	46.16	46.16	1.02	–	0.17	0.06	46.50	46.22
Total Proved + Probable	69.25	69.25	3.98	–	0.48	0.25	70.39	69.50

"Gross" reserves are defined as the total remaining recoverable reserves owned by the Company before deduction of any royalties.

"Net" reserves are defined as those accruing to the Company after royalties have been deducted or included.

RUSSIA

ZA PADNO
CHUM PASSKOYE
LICENSE
WESTERN SIBERIA
0
10 km
LEGEND
License
Fields
Oil Pipelines
Gas Pipelines

ZAPADNO-CHUMPASSKOYE LICENSE

In the fourth quarter of 2005, Heritage acquired a 95% equity interest in ChumpassNefteDobycha Limited, a Russian company whose sole asset is the Zapadno-Chumpasskoye License, an exploration and production permit previously held by Tyumenskaia Neftanaia Komaniya (now known as TNK-BP).

Expiring in September 2024, the license is in West Siberia in the province of Khanty-Mansiysk, approximately 100 kilometres from the city of Nizhnevartovsk in the vicinity of TNK-BP's prolific Samotlor Field. It is located in a hydrocarbon-rich province close to well-developed infrastructure. The license has an area of approximately 200 square kilometres and contains the Zapadno-Chumpasskoye Field (West Chumpass), which was discovered in 1997. A total of nine wells were drilled in the license prior to 2005. The reservoir is a sandstone of Late Jurassic age at a depth of approximately 2,700 metres, which is the same producing horizon as in a number of the neighbouring fields.

Heritage commenced development of the West Chumpass field in 2006. A 200 kilometre 2D seismic survey was acquired, civil works were undertaken and the existing well #226 was re-entered. Well #226 preliminary free-flow test produced 124 barrels of oil over a five hour period, with no water, at a flowing wellhead pressure of 1,180 psi. This corresponds to approximately 600 bopd. An operational office, employing over 20 people, has been established in the neighbouring city of Nizhnevartovsk.

A multi-well drilling program commenced in April 2007, from which the first three wells to be drilled will satisfy the remaining license commitments. Further production tests are to be carried out in the second quarter following commissioning of production facilities in the field.

Commercial production from the field is expected to commence in the second quarter of 2007, reaching an estimated peak of approximately 18,000 bopd in 2012. Total gross development costs of the field are estimated by RPS Energy at approaching $300 million and are anticipated to be incurred up to 2011, with peak expenditure expected in 2007 and 2008.

RPS Energy estimated the West Chumpass field to have proved reserves of 23 million barrels and additional probable reserves of 46 million barrels net to Heritage. They also estimated the Net Present Value, discounted at 10%, at US$279 million on a constant price basis and US$250 million on an escalated price basis, net to Heritage, effective December 31, 2006.

STRATEGIC ALLIANCES

In the last quarter of 2006, Heritage entered into an agreement with TISE Holding Company to establish a jointly-owned company, TISE HERITAGE NEFTEGAS, which will appraise and acquire oil and gas opportunities in Russia and internationally. Shareholders of TISE Holding Company include Concord, Zarubejneft, Zarubejneftegas (a wholly-owned Gazprom subsidiary), Technopromexport and Zarubejstroymontaj.

KEY FACTS

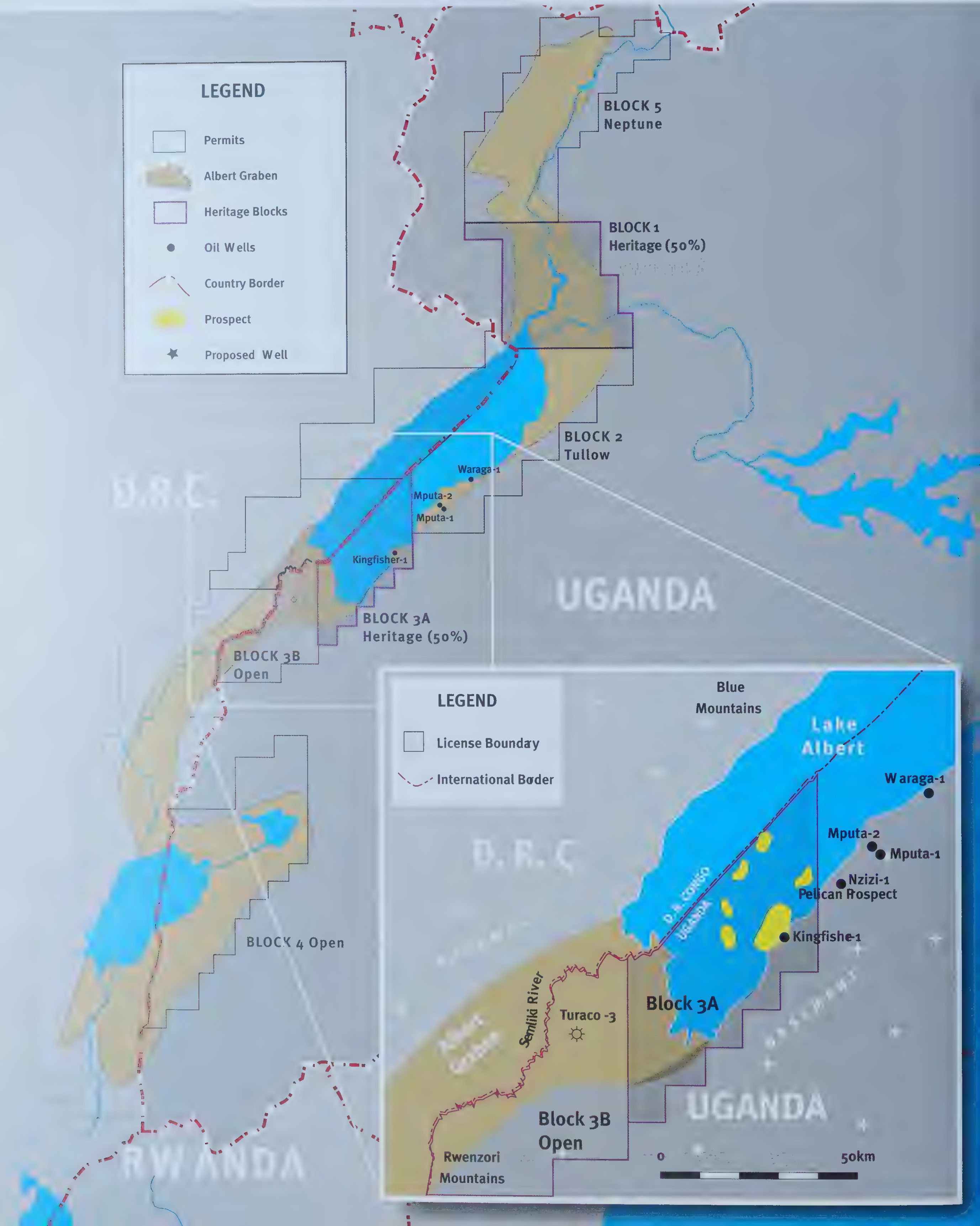
ZAPADNO-CHUMPASSKOYE EXPLORATION AND DEVELOPMENT PERMIT

- **Ownership: Heritage 95%**

Multi-well drilling program commenced April 2007.

Commence commercial production in Q2 following commissioning of production facilities. Successful free-flow test which produced 124 barrels of oil over a five hour period (equating to 600 bopd) at the end of 2006.

UGANDA


LEGEND
Permits
Albert Graben
Heritage Blocks
Oil Wells
Country Border
Prospect
Proposed Well
BLOCK 5
Neptune
BLOCK 1
Heritage (50%)
BLOCK 2
Tullow
Waraga-1
Mputa-2
Mputa-1
Kingfisher-1
BLOCK 3A
Heritage (50%)
BLOCK 3B
Open
BLOCK 4 Open
D.R.C.
UGANDA
RWANDA
LEGEND
License Boundary
International Boder
Blue
Mountains
Lake
Albert
W araga-1
Mputa-2
Mputa-1
Nzizi-1
Pelican Prospect
Kingfishe-1
D.R. CONGO
UGANDA
D. R. C
Block 3A
Semliki River
Turaco -3
Albert
Graben
Block 3B
Open
UGANDA
Rwenzori
Mountains
0
50km

BLOCK 3A

The original Block 3 license in the Albert Basin of Western Uganda was awarded in 1997. The Block 3A license, which covered an area very similar to the original Block 3 license, was awarded in 2004. During 2006, the Company relinquished the southern part of the Block, covering the Semliki flats where the Turaco wells had been drilled, reducing the area of Block 3A to 2,024 square kilometres. This retained area covers the southern Ugandan waters of Lake Albert, where the 2006 drilling program was concentrated.

The drilling of the Kingfisher-1 well commenced on August 15, 2006 and reached a total depth of 3,195 metres, which was close to the limit of the rig's operational capability. Subsequent to the completion of production testing operations and the suspension of the well, the rig was released on March 17, 2007.

Four intervals, totalling a thickness of 54 metres, were production tested successfully in the Kingfisher well at an overall cumulative flow rate of 13,893 bpd, through a one inch choke. The oil is light (between 30º and 32º API) and sweet with a low gas-oil ratio and some associated wax. The tested reservoirs are sandstones with high permeability of up to 3,000 milliDarcies.

The Kingfisher prospect is a very large structural high that is expressed at surface on the bed of Lake Albert, and seismic data indicates it extends to an area of up to 70 square kilometres. This first exploration well therefore only investigated one limited area, and has not yet drilled the deepest parts of the structure, which contain the primary objective target reservoirs for the well.

Looking forward to 2007, Heritage has contracted IMC Geophysics to acquire a circa 325 square kilometre 3D seismic program over the Kingfisher and neighbouring Pelican prospects. Mobilisation of the equipment commenced at the beginning of the second quarter. Further appraisal drilling of the Kingfisher prospect will commence following the processing and interpretation of the 3D data. Efforts are currently underway to secure a higher capacity drilling rig capable of deeper drilling to explore the deepest objectives not penetrated by the Kingfisher-1 well. Drilling on Kingfisher is scheduled to recommence in the fourth quarter of 2007.

In addition, plans are being developed to drill the offshore Pelican prospect and other targets within Lake Albert in 2008.

BLOCK 1

Block 1 was awarded in 2004 in order to consolidate the Company's position in the basin. The Block covers an area of 3,660 square kilometres. A circa 500 kilometre 2D seismic acquisition program, again undertaken by IMC Geophysics, commenced in February 2007. An exploration well is planned for 2008.

KEY FACTS

BLOCK 3A, LICENSE 2/04 EXPLORATION AREA

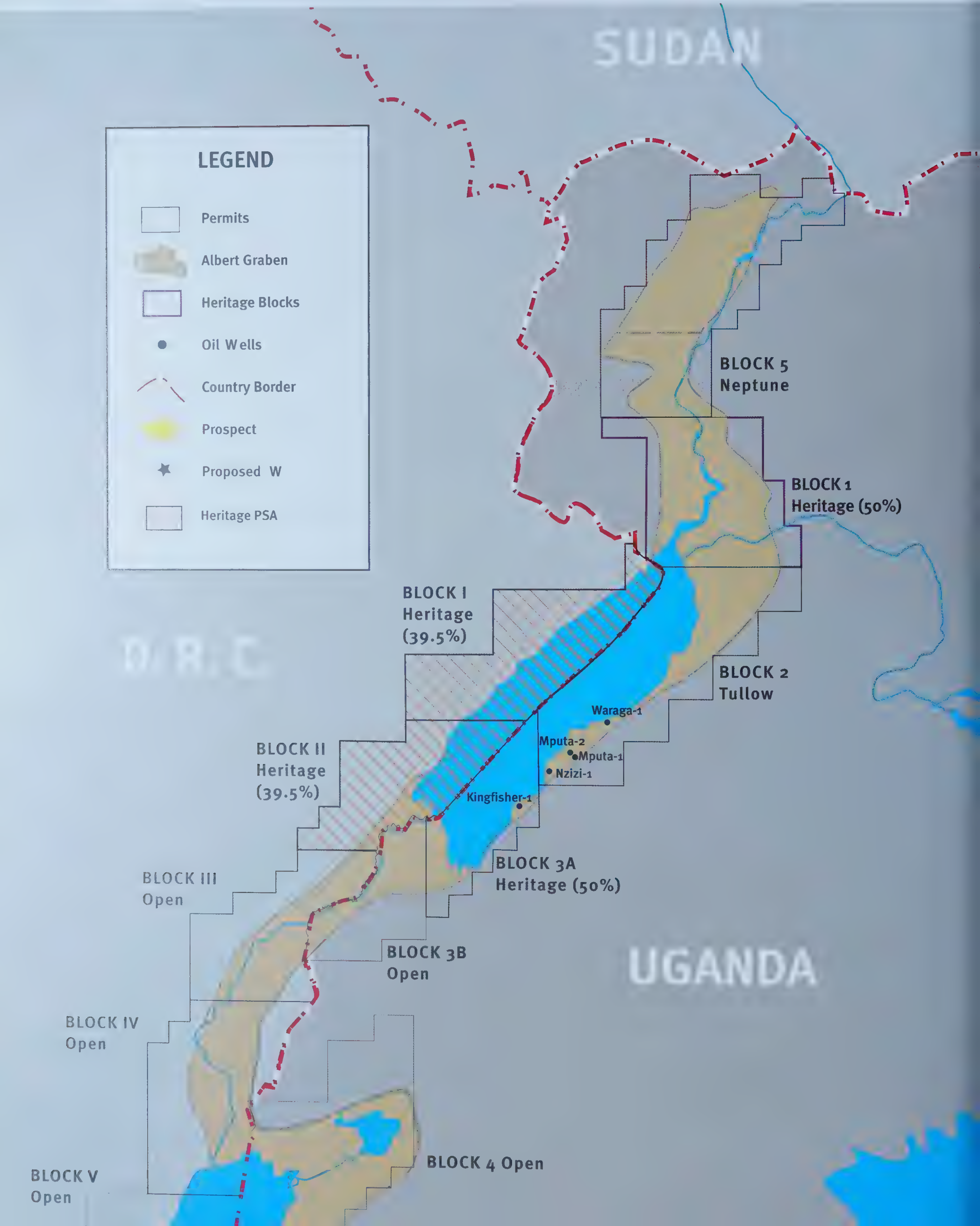
- **Ownership: Heritage 50% (operator), Tullow Oil plc 50%.**

BLOCK 1, LICENSE 1/04 EXPLORATION AREA

- **Ownership: Heritage 50% (operator), Tullow Oil plc 50%.**

Blocks 3A and 1 are located in the Albert Basin, which forms part of the western arm of the East African rift valley bordering the Democratic Republic of Congo.

DEMOCRATIC REPUBLIC OF CONGO



BLOCKS I & II

In 2006, Heritage and its partner Tullow Oil executed a Production Sharing Agreement (PSA) with the Government of DRC covering Blocks I & II. The Blocks cover the entire area of Lake Albert that lies within DRC, adjacent to Heritage's Block 3A and Tullow Oil's Block 2 in Uganda, plus a smaller area onshore in the south.

Work is expected to commence on the Blocks following a Presidential Decree ratifying the PSA, with a circa 400 kilometre 2D seismic acquisition on Lake Albert in 2007. This seismic program will target potential extensions to the geological play types that have proved successful in Heritage's Kingfisher well and in Tullow Oil's discoveries in Block 2 in Uganda.

Together, these two DRC Blocks cover over 6,000 square kilometres, further consolidating Heritage's acreage position in the Albert Basin.

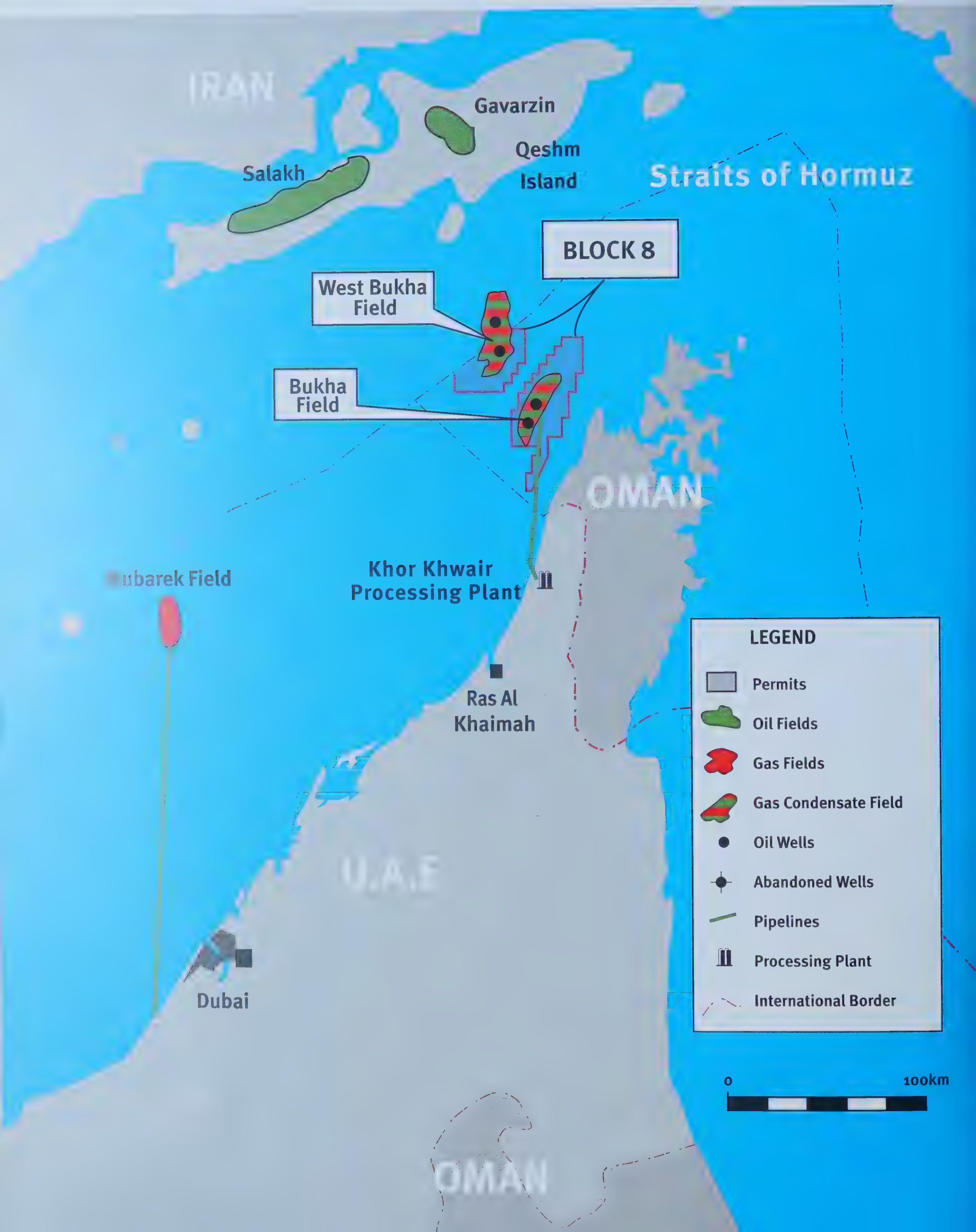
KEY FACTS

BLOCKS I & II

- **Ownership: Heritage 39.5%, Tullow Oil (operator) 48.5%, COHYDRO 12%.**

PSA awarded in 2006. Seismic survey to be acquired following award of Presidential Decree. This will target potential extensions to the geological play types that have proved successful in the Uganda licenses.

SULTANATE OF OMAN



BLOCK 8

Block 8 covers 379 square kilometres in about 90 metres of water roughly 12 kilometres offshore Musandam Peninsula, Oman, representing Oman's only offshore production.

BUKHA FIELD

The Bukha field produces from wells Bukha-1 and Bukha-2 and commenced production in 1994. Overall, gross production of liquids from the Bukha field declined by 11% to 1,833 bopd in 2006, which is in line with expectations for this mature asset.

Production is piped into a processing plant onshore Ras Al Khaimah, which is operated by the state gas company, Rakgas. There the gas condensate is stored for subsequent lifting when logistically economic quantities are accumulated and sold to a third party under an annual contract. Liquid petroleum gas (LPG) is sold to Rakgas and the residual gas is sold by Rakgas to local cement factories. The Company is not paid directly for the gas but benefits from the arrangement by receiving highly preferential processing and storage charges.

A 3D seismic survey was acquired over the entire field in 2006. The joint venture plans to re-map the field based on the new 3D survey with a view to drilling wells into areas of the field which may not be drained by the two existing producing wells. Mapping of the Bukha field suggests a region of the field to the northeast (known as North Bukha) that is likely to be separated by faulting from the area being drained by the current wells. This region will likely require an additional production well tied back to the current facilities in order to be produced, which is to be considered by the joint venture partners in the future.

WEST BUKHA FIELD

The West Bukha/Hengam field extends over the Oman-Iran border in the Straights of Hormuz, approximately 30 kilometres west of the Musandam Peninsula in about 90 metres of water.

In May 2006, the West Bukha-2 appraisal/development well was spudded, targeting cretaceous-age carbonates (the same formations as at Bukha) in a large, gas-condensate accumulation straddling the Oman-Iran border. This well was a success and test produced at a combined flow-rate from the Ilam/Mishrif/Mauddud and Thamama reservoirs of approximately 12,750 bopd and 26 MMscf/d. The oil was light (approximately 42 °API).

The joint venture has been granted Omani Government approval to develop reserves which lie on the Omani side of the field, approximately 20 kilometres from Bukha. The operator is in the process of up-dating its development plan to take into account the success of the West Bukha-2 well, notably the higher portion of liquid hydrocarbons. The development is on-going with plans for the installation of a platform and pipeline to deliver the petroleum fluids to markets in Ras Al Khaimah via the Bukha system. First commercial production is anticipated in the first half of 2008.

KEY FACTS

BLOCK 8 DEVELOPMENT PERMIT (CONTAINS THE BUKHA AND WEST BUKHA FIELDS)

- **Ownership: Heritage 10%, Rak Petroleum 40% (operator), LG International 50%.**

Continue to develop the West Bukha field, including design, fabrication and installation of the wellhead platform and pipeline to enable production to commence in the first half of 2008.

IRAQ AND THE KURDISTAN REGION OF IRAQ

IRAQ AND THE KURDISTAN REGION OF IRAQ

The oil and gas potential of Iraq is vast; the country has the second largest conventional oil reserves in the world with approximately 115 billion barrels of oil and 110 trillion cubic feet of gas, yet less than 10% of the country has been explored.

Heritage is initially focusing on the Kurdistan Region of Iraq as the security situation in this region allows oil and gas companies to start exploration activities. Heritage has maintained a presence in the country since opening an office in Erbil in August 2005, and in 2006 has undertaken field geological and geophysical surveys. Kurdistan is a region that is highly prospective and under-explored for hydrocarbons; a number of local experts believe it could have potential oil reserves in the multiples of billions of barrels.

Subsequent to the year-end, Heritage submitted an application for a production sharing agreement to the Minister of Hydrocarbons of Kurdistan, and it is hoped a license will be awarded later this year, following the promulgation of the oil and gas law of Iraq and Kurdistan. The draft oil and gas law, prepared by the Council of Ministers and the Oil and Energy Committee, dated February 15, 2007, has been sent to the Iraqi Parliament for approval, and it is anticipated that the ratification process may be completed in the summer of 2007, after Parliament approval.

During 2006, Heritage made progress in Southern Iraq. A steering committee was established with the Ministry of Oil to identify existing fields of interest and to undertake desk-top field studies to prepare development plans. Heritage is therefore well-situated to be awarded licenses over these fields in the future.

In 2004, Heritage co-sponsored an upstream and downstream training course in Portugal. This was repeated in 2006, with the result that over 65 officials from the Ministries of Oil of Iraq and Kurdistan have attended these courses.

KEY FACTS

Heritage is pursuing opportunities in the Kurdistan region of Iraq and in other areas of Iraq.

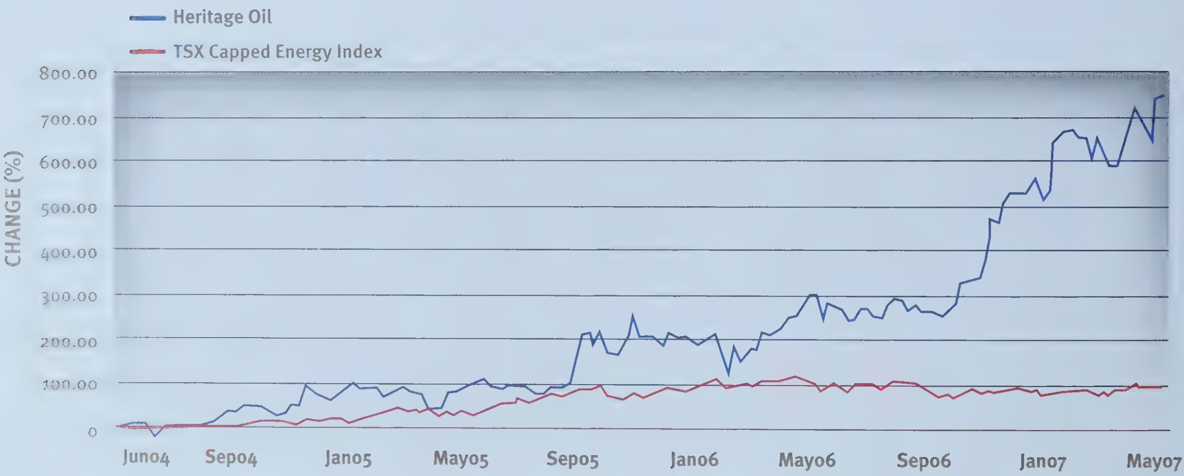
Application for a PSA submitted in 2007. License award is expected soon after Iraqi Parliament approval of the new hydrocarbon law.

SHAREHOLDER ISSUES

Heritage continues to create financial value for its shareholders through selected asset acquisitions, development and dispositions. As is typical in the sector, long-term returns to shareholders should reflect the value created in the Company, primarily through higher share prices. Over time, value will be reflected to a greater extent by increased share price rather than through dividend distributions, although the Company may consider returning any surplus windfall cash to shareholders if the Directors believe it cannot be used for development purposes.

In 2006, shareholder value continued to improve significantly, with the share price rising by 113% between January 1, 2006 and December 31, 2006. The share price has continued to rise since the year-end, hitting a new high of Cdn$40.00 per share compared to the closing price of Cdn$30.75 as at December 31, 2006. Over the course of the last few years, the share price significantly outperformed the TSX Capped Energy Index as shown by the graph below.

HOC RELATIVE PERFORMANCE



The Company continues to assess means of generating further shareholder value and liquidity and is examining a secondary listing in Europe. A secondary listing is expected to increase trading volumes and introduce the Company to a wider investor audience.

In order to capture the greatest possible value over time, it is imperative that the Company has at its disposal adequate financial resources. Heritage is continually developing new programs to communicate and meet with the financial community. This has included appointing investor relations experts and financial advisers, as well as attending and speaking at leading oil and gas conferences.

The Company strives to provide investors with the best possible basis for share price determination by means of accurate, comprehensive and timely information. Updated information can be found on the website at www.heritageoilcorp.com.

In order to focus attention on shareholder value and the overall goals of the Company, Heritage periodically issues stock-based compensation as part of the remuneration package to Directors and senior management.

DIRECTORS AND SENIOR MANAGEMENT TEAM

MICHAEL HIBBERD

CHAIRMAN, DIRECTOR

Mr. Hibberd has extensive international energy project planning and capital markets experience, having spent 12 years in corporate finance with ScotiaMcLeod where he was a director and Senior Vice-President, Corporate Finance. Mr. Hibberd is currently President of MJH Services Inc. and serves as a director of AltaCanada Energy Corp., Challenger Energy Corp., Iteration Energy Ltd., Pan Orient Energy Corp., and Rally Energy Corp. Mr. Hibberd also served as a director of Deer Creek Energy Limited until December 2005. He joined Heritage in March 2006.

ANTHONY BUCKINGHAM

CHIEF EXECUTIVE OFFICER, DIRECTOR

Mr. Buckingham is the founder of the Heritage Group. He commenced his involvement in the oil industry as a North Sea diver and subsequently became a concession negotiator. Mr. Buckingham is a former advisor to Premier Consolidated Oilfields plc, Sonangol and Ranger Oil. He introduced Premier into Pakistan and Ranger into Angola where he was instrumental in forming Sonangol P&P as a leading operator.

PAUL ATHERTON

CHIEF FINANCIAL OFFICER, DIRECTOR

Mr. Atherton is a chartered accountant, having qualified with Deloitte & Touche, and holds a degree in geology. He has a corporate finance background with specific experience in the international mining and resource sectors. Mr. Atherton is a director of SeaDragon Offshore Ltd. He joined Heritage in 2000 and was appointed as a director in 2005.

WILLIAM KAUFMANN

NON EXECUTIVE DIRECTOR

Mr. Kaufmann holds an MA in Geology. He has held senior management positions in the petroleum industry including President of Canterra Petroleum Inc. (U.S.A.) from 1983 to 1986 and Senior Vice President of Exploration of Canterra Energy from 1981 to 1988. Until 1998, Mr. Kaufmann was the Chief Operating Officer of the Calgary Chamber of Commerce and is a director of University Technology International, the McMahon Stadium Society and Bow Valley College.

JOHN MCLEOD

NON EXECUTIVE DIRECTOR

Mr. McLeod is a professional engineer with over 35 years of varied resource extraction experience. Mr. McLeod is President & CEO of California Oil & Gas Corp., a public company, and has held senior operational, engineering and management positions both domestically and internationally. Currently Mr. McLeod serves as a director of Highview Resources Ltd., Castle Rock Petroleum Ltd., Tuscany Energy Ltd., Diaz Resources Ltd., Consolidated Beacon Resources Ltd. and Keeper Resources Inc. Mr. McLeod is the current President of the Association of Professional Engineers, Geologists and Geophysicists of Alberta (APEGGA).

DIRECTORS AND SENIOR MANAGEMENT TEAM

GREGORY TURNBULL

NON EXECUTIVE DIRECTOR

Mr. Turnbull is the Regional Managing Partner of the Calgary office of the law firm of McCarthy Tétrault LLP. During his 25 year career with various legal practices, he has dealt with all aspects of public companies. He has been actively involved in the IPOs of more than 40 companies. Mr. Turnbull has experience in a variety of corporate activities as well as an extensive knowledge of corporate governance issues and has acted for many boards of directors and special committees in that regard.

ARMEN SAHAKIAN

VP BUSINESS DEVELOPMENT

Dr. Sahakian received his doctorate in geology from Harvard University. Dr. Sahakian has 30 years experience in the oil industry and has held senior management positions in business development and international petroleum negotiations. The companies and institutions he has worked for include Conoco, Hispanoil, Partex-CPS, OMV and as petroleum advisor on the World Bank's Oil and Gas Division's financed petroleum projects.

BRIAN SMITH

VP EXPLORATION

Mr. Smith has 29 years experience in the oil industry. He initially worked as an exploration geologist for Exxon in the North Sea and Gulf of Mexico. Later he joined Enterprise Oil where he managed various exploration projects in the Far East and Eastern Europe/FSU. He joined Heritage as Vice President Exploration in 1997.

STEPHEN KOBAK

VP PRODUCTION RUSSIA AND CIS

Stephen Kobak, a qualified engineer, has twenty seven years experience in oil and gas production operations, reservoir studies and asset development. The companies he has worked for include ESSO, Shell International and Khanty Mansiysk Oil Corporation in Western Siberia where he held senior management positions guiding technical and operations activities. He has extensive international experience working in Russia, the Far East, Middle East and Canada. Mr. Kobak joined Heritage in 2007.

JAMES BABAN

COUNTRY MANAGER, KURDISTAN

Mr. Baban has over 30 years experience in the upstream oil and gas industry. Mr. Baban is a Chartered Engineer and a Fellow of The Energy Institute in UK and has previously worked for Petro-Canada, Burlington Resources, Veba Oil, BP & BG. He has extensive skills in the development and management of international offshore and onshore projects, having worked in the Middle East, Far East and North Africa. Mr. Baban joined Heritage in 2005.

CORPORATE GOVERNANCE

The Directors are committed to maintaining the highest standards of corporate governance and this statement describes how the Principles of Good Corporate Governance are applied.

BOARD COMPOSITION

The Board consists of six directors of which three are non-executive Canadian directors. The non-executive directors are experienced, independent energy professionals from the legal, financial, technical and management sectors, providing a range of expertise and experience.

ROLE OF THE BOARD

The primary duties and responsibilities of the Board of Directors are to:

- Approve, monitor and provide guidance on the strategic planning process. The Chairman, CEO, CFO and senior management team have direct responsibility for the ongoing strategic planning process and the establishment of long-term goals for the Company.
- Identify the principal risks of the Company's business and take reasonable steps to ensure the implementation of appropriate systems to manage and monitor these risks.
- Delegate to the Chairman, CEO and CFO the authority to manage and supervise the business of the Company, including the making of all decisions regarding the Company's operations that are not specifically reserved to the Board of Directors under the terms of that delegation of authority. The Board also determines what, if any, executive limitations may be required in the exercise of the authority delegated to management, and in this regard approves operational policies within which management will operate.
- Monitor the Company's financial position and approve budgets.
- Oversee the integrity of the Company's internal control and management information systems.
- Oversee effective communication with shareholders.

The Board meets regularly throughout the year and all the necessary information is supplied to the Directors on a timely basis to enable them to execute their duties effectively.

AUDIT COMMITTEE

The purpose of Heritage's Audit Committee is to provide assistance to the Board of Directors of Heritage in fulfilling its legal and fiduciary obligations with respect to matters involving the accounting, auditing, financial reporting, internal control and legal compliance functions of the Company and its subsidiaries.

The Audit Committee is responsible for the review and approval of the quarterly financial statements, management's discussion and analysis, all press releases containing financial disclosure, and the Company's oil and gas reserves reporting. The Committee recommends to the Board the appointment and remuneration of the external auditors. The external auditors report directly to the committee. All non-audit work performed by the external auditors is to be approved by

CORPORATE GOVERNANCE

the Committee. The Committee also has oversight responsibility for the internal control systems that management has established.

The Audit Committee is composed of William Kaufmann, John McLeod and Michael Hibberd. Committee members are independent and financially literate.

INDEPENDENT EXTERNAL ADVICE

The Board or individual directors may request the provision of independent professional advice in relation to exercising their duties as directors at the Company's expense upon approval of the Chairman.

FINANCIAL RISK MANAGEMENT

The Board maintains oversight responsibility for the risk management programs relating to commodity prices, foreign exchange, interest rates and credit risks.

SHAREHOLDER COMMUNICATIONS

The Board aims to ensure that shareholders are informed of all major issues affecting the Company's state of affairs, reporting to shareholders through its quarterly and annual reports plus press releases. Procedures are in place to ensure price sensitive information is reported to the TSX and the securities commissions in advance with disclosure requirements. Regular updates to record news and results are published on the Company's website (www.heritageoilcorp.com), which also has a link to the TSX so that the Company's share price may be monitored.

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements that are generally identifiable by terms such as anticipate, believe, budget, intend, estimate, expect, outlook, plan or other similar words, and include future capital investment plans. The reader is cautioned that assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be incorrect. Actual results achieved during the forecast period will vary from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors.

Such factors include, but are not limited to: general economic, market and business conditions; fluctuations in oil and gas prices; the results of exploration and development of drilling and related activities; fluctuation in foreign currency exchange rates; the uncertainty of reserve estimates; changes in environmental and other regulations; risks associated with oil and gas operations; risks associated with foreign operations and other factors, many of which are beyond the control of the Company. There is no representation by Heritage that actual results achieved during the forecast period will be the same in whole or in part as those forecast.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis (the "MD&A") is dated March 29, 2007 and should be read in conjunction with the Company's audited consolidated financial statements for the years ended December 31, 2006 and 2005, together with accompanying notes.

The MD&A is management's view of Heritage Oil Corporation's (the "Company" or "Heritage") operating and financial data for 2006 and 2005, as well as forward-looking operations and financial estimates. Forward-looking statements are generally identifiable as any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events of performance. Such statements are not historical facts and may be forward-looking and may involve estimates, assumptions and uncertainties which could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements. The reader is cautioned that assumptions used in the preparation of such information, although considered reasonable at the time of preparation, may prove to be incorrect. Actual results achieved during the forecast period will vary from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors. Such factors include, but are not limited to: general economic, market and business conditions; fluctuations in oil and gas prices; the results of exploration and development of drilling and related activities; costs and availability of services; political risks; fluctuation in foreign currency exchange rates; the uncertainty of reserve estimates; changes in environmental and other regulations; and other factors, many of which are beyond the control of the Company. See "Business Risks and Uncertainties".

The MD&A is presented in the following sections:

I. Business Strategy provides a description of the Company's development strategies.

II. Operational and Financial Highlights provides a summary of the operations review and financial statement analysis for the year.

III. Detailed Financial Analysis provides a detailed analysis of the Company's financial performance by focusing on the income statement, the balance sheet and the statement of cash flows that are included within the audited financial statements.

IV. Selected Quarterly Information provides the Company's key financial results, such as petroleum sales and net earnings, as well as the trading range of the Common Shares on a quarterly basis.

V. Outlook for 2007 provides an overview of the Company's capital expenditures for 2007 and estimated levels of production for 2007.

VI. Critical Accounting Estimates provides a discussion of the more significant accounting policies. These are intended to enhance investors' understanding regarding the sensitivity of reported financial results to the methods, assumptions, and estimates that underlie the preparation of the financial statements in accordance with generally accepted accounting principles.

VII. Internal Controls over Financial Reporting provides an overview of the Company's internal controls.

VIII. Business Risks and Uncertainties provides a discussion of the various business risks the Company is exposed to and the measures it follows to mitigate these risks.

I. BUSINESS STRATEGY

Heritage's goal is to deliver growth in shareholder value, by applying the following strategies:

- Investment in world-class hydrocarbon basins primarily in the Middle East, Russia, Africa and Pakistan.
- High impact exploration programs focused on basins containing multiple targets with the potential to discover large reserves of oil.
- Investing in properties that either already produce or are close to producing and generally represent relatively low exploration risk.
- Management of technical and political risk through a geographic spread of licenses, and an experienced hands-on management team.

These strategies are currently focused on the following prolific hydrocarbon areas: Russia, the Kurdistan Region of Iraq and other areas of Iraq, and on potential hydrocarbon areas in Africa, principally in Uganda.

Significant increases in the Company's market value are expected to be achieved:

- Internally, through high impact exploration drilling programs and the acquisition of seismic surveys in the Albert Basin in Uganda and the Democratic Republic of Congo.
- Internally, through production and development drilling programs in Russia and the Middle East.
- Internally, through the commencement of commercial production in Russia in 2007 and the commencement of production from the West Bukha oil discovery in Oman in 2008.
- Internally, by negotiating the award of new license concessions, most notably in the Kurdistan Region of Iraq. This region offers tremendous long-term growth potential for Heritage.
- Externally, by acquisition. Through its network of relationships, the Company has identified a number of attractive potential acquisitions that continue to be appraised.
- Externally, by joint ventures with established local parties. Historically, Heritage has entered into a number of strategic joint ventures, notably in Russia.

II. OPERATIONAL AND FINANCIAL HIGHLIGHTS

Heritage's operating and financial highlights for the last 15 months include the following (all values are in US dollars except where otherwise stated):

- In Uganda, the Kingfisher deviated well in Block 3A (Heritage operator, 50% interest) spudded in August 2006 and was drilled to a total depth of 3,195 metres, which was close to the limit of the rig's operational capability. Four intervals were tested successfully, producing an overall cumulative flow rate of 13,893 barrels of oil per day ("bopd") through a one inch choke. A shallower interval, at a depth of 1,783 metres, was tested in November 2006, producing 4,120 bopd from a 10 metre interval. Three deeper intervals were tested in February 2007, from between 2,260 metres to 2,367 metres, and produced a cumulative flow rate of 9,773 bopd over a total net productive thickness of 44 metres. The tested oil is good quality light (between 30° and 32° API) and sweet with a low gas-oil ratio and some associated wax. The reservoirs are sandstones with high permeability of up to 3,000 milliDarcies.

- Heritage signed a Production Sharing Agreement in the Democratic Republic of Congo ("DRC") during the summer of 2006 for a 39.5% interest in Blocks I and II in the prospective Albert Basin. Blocks I and II cover over 6,000 square kilometres of onshore and offshore acreage in the DRC part of the Albert Basin that extends into neighbouring Uganda. The work program, including a seismic campaign, will commence when the DRC Presidential Decree has been issued.

- In the last quarter of 2006, the West Bukha-2 appraisal/development well in Block 8 Oman (10% interest) test produced a combined flow-rate from two zones (Ilam/Mishrif/Mauddud and Thamama) of approximately 12,750 bopd and 26 MMscf/d. The oil was light (approximately 42 °API). Phase I of West Bukha development has commenced and includes design, fabrication and installation of the wellhead platform and pipeline. Production is targeted to commence in the first half of 2008.

- In the last quarter of 2006, Heritage entered into an agreement with TISE Holding Company to establish a jointly-owned company, TISE HERITAGE NEFTEGAS, to appraise and acquire oil and gas opportunities in Russia and internationally. Shareholders of TISE Holding Company include Concord, Zarubejneft, Zarubejneftegas (a wholly-owned Gazprom subsidiary), Technopromexport and Zarubejstroymontaj. The profile, strength and stature of TISE and its shareholders should ensure Heritage's operations in Russia are undertaken in an efficient and transparent manner.

- Heritage commenced development of the West Chumpass field (Heritage operator, 95% interest) in West Siberia in 2006. A 200 km 2D seismic survey was acquired, civil works were undertaken and an existing well was re-entered culminating in the test of well #226. Well #226 preliminary free-flow test produced 124 barrels of oil over a five hour period, with no water, at a flowing wellhead pressure of 1,180 psi. This corresponds to approximately 600 barrels of oil per day.

- Heritage completed the sale of its interests in the Republic of Congo ("Congo") which generated a one-off gain in 2006 of $9,950,968.

  - On November 22, 2006, Heritage completed the sale of Heritage Congo Limited, which held a 14% working interest in the Noumbi Exploration Permit, to Afren PLC ("Afren") for the following consideration:

    - Cash of US$21,000,000, which has been received.

    - 1,500,000 Afren warrants, with a term of five years and an exercise price of £0.60 GBP Sterling per share.

  - On January 18, 2007, the Company finalized the statement of adjustments relating to the sale of its 25% working interest in the Kouakouala A and its 30% working interest in the Kouakouala B license in Congo to the other partners in the licenses, Maurel et Prom and Burren Energy, for the following consideration:

    - Cash of US$6,052,515, which has been received.

    - An overriding royalty of 15% over a 30% working interest in the Kouakouala B license in relation to the Mengo Field. The Mengo Field is not in production.

All of the disposition agreements were completed in 2006. The results of operations in Congo have been classified as results of discontinued operations since 2005 and the related net assets classified as assets and liabilities of discontinued operations.

- On March 27, 2006, Heritage issued 600 unsecured senior convertible bonds each with a par value of $100,000 for aggregate proceeds of $60,000,000. The bonds had a coupon rate of 10% per annum, a term of five years and one day

and were convertible into Common Shares at a price of US$18.00 per share. Heritage had the right to redeem, in whole or part, the bonds for cash at any time on or before March 28, 2007 at 150% of par value. The proceeds of the bonds could be employed for development of the West Chumpass field in Russia and for general corporate purposes. On January 17, 2007, the Company gave notice that it had exercised its option to redeem the 550 outstanding unsecured senior convertible bonds at 150% of par value for total proceeds of $82,500,000, plus accrued interest which was paid on March 28, 2007. A total of 50 of the unsecured convertible bonds, with a total par value of $5,000,000, were converted into Common Shares at an exercise price of US$18.00 per share subsequent to December 31, 2006.

- On February 16, 2007, the Company raised US$165,000,000 by completing a private placement of convertible bonds. The Company issued 1,650 unsecured senior convertible bonds, each with a par value of $100,000, which have a term of five years and one day and an annual coupon of 8.00%. The bonds are convertible into Common Shares at a price of US$47.00 per share. The Company may redeem, in whole or part, the bonds for cash at any time on or before February 16, 2008, at 150% of par value. A portion of the proceeds were used to finance the redemption of the outstanding $55 million of convertible bonds at a premium of 150% referred to in the paragraph above and for general corporate funding purposes.

United States dollars		Year ended December 31,	
		2006	2005
Revenue:			
Petroleum and natural gas	$	3,938,512	841,766
Drilling rig		2,895,727	342,359
Interest		1,767,898	330,290
		8,602,137	1,514,415
Expenses:			
Petroleum and natural gas operating		723,611	465,110
Drilling rig operating		2,291,585	196,804
General and administrative		8,977,345	5,249,649
Financing charges		5,996,553	491,824
Foreign exchange losses		798,194	1,170,906
Depletion, depreciation and accretion		691,011	536,093
Impairment of unproved petroleum and natural gas interests		986,964	724,915
		20,465,263	8,835,301
Loss from continuing operations		(11,863,126)	(7,320,886)
Gain on disposal of discontinued operations		9,950,968	–
Earnings from discontinued operations		3,248,490	3,521,073
Net earnings (loss) for the year		1,336,332	(3,799,813)

III. DETAILED FINANCIAL ANALYSIS

PRODUCTION

Heritage's net 2006 condensate and LPG production averaged 169 bopd, 21% higher than the previous year. Production may be analysed as follows:

Average net production	2006	2005
	Bopd	Bopd
Oman		
Condensate	105	69
LPG	64	71
	169	140

Net production from the Bukha field, Oman increased from 140 bopd in 2005 to 169 bopd in 2006, due to an increase in Heritage's share of production resulting from higher cost recoveries from the drilling of the West Bukha well in May 2006. Overall, gross field production of liquids declined by 11% to 1,833 bopd in 2006, which is in line with expectations for this mature asset.

PETROLEUM AND NATURAL GAS REVENUE

Petroleum and natural gas revenue may be analyzed as follows:

	2006	2005	2006	2005
	$	$	$/bbl[1]	$/bbl[1]
Oman				
Condensate	3,535,267	468,816	64.79	52.24
LPG	403,245	372,950	17.05	14.70
	3,938,512	841,766	50.36	24.51

[1] *As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.*

Petroleum and natural gas revenue increased by $3,096,746 (368%) in 2006 to $3,938,512. $2,208,665 of this increase resulted from a 128% increase in sales volumes as a result of the periodic nature of condensate sales and $888,081 from a 106% increase in the weighted average commodity prices. The average sales price per barrel increased from $24.51 in 2005 to $50.36 in 2006.

Condensate production from the Bukha field, Oman was sold to Sumitomo Company in 2005 and 2006.

DRILLING RIG REVENUE

Third party drilling rig revenue of $2,895,727 in 2006 was generated from Heritage's 50% share of Eagle Drill's sales to third parties. Eagle Drill has drilled four wells and tested two wells in Block 2, Uganda since December 2005. Revenue in 2005 totalled $342,359.

INTEREST AND OTHER INCOME

Interest income of $1,767,898 in 2006 was $1,437,608 higher than the previous year, as a result of both average higher cash balances and higher average interest rates in 2006. Cash and cash equivalents are typically held in interest-bearing treasury accounts. Invested cash generating this income was raised by the issue of the $60 million unsecured, convertible bonds on March 27, 2006.

OPERATING EXPENSES

In 2006, petroleum and natural gas operating costs of $723,611 were 56% higher than in 2005, as a result of increased condensate sales volumes from the Bukha field, Oman.

Operating expenses from drilling operations were $2,291,585, compared to $196,804 in the prior year, due to the substantial increase in third party drilling operations.

GENERAL AND ADMINISTRATIVE

General and administrative expenses increased from $5,249,649 in 2005 to $8,977,345 in 2006, an increase of $3,727,696. The increase may be analysed as follows:

- In 2006 the Company trained 40 officials from the Ministry of Oil of Iraq and the Ministry of Natural Resources in Portugal at a cost of $720,000. A previous training course was undertaken in 2004, whilst no training was held in 2005. The Company considers the Iraq training programs an excellent way of further developing and cementing ties with Ministry officials from Iraq. The Company has now trained more than 65 Ministry officials.

- The stock based compensation expense in the year increased from $625,365 in 2005 to $1,483,945 in 2006, an increase of $878,220, primarily as a result of the 550,000 options granted in 2006.

- The Company has continued to grow substantially, employing additional staff, appraising and undertaking operations in new territories. The Company's increased level of activity during the last 12 months can generally be linked to the acquisition of the West Chumpass field in Russia, preparation for drilling in Uganda and initiatives in the Kurdistan region of Iraq and Southern Iraq. Fees and expenses paid to technical members of staff and consultants increased by $1,530,000 in 2006, accounting for the majority of the remaining increase of $2,149,116.

In 2006, the Company capitalized $2,813,303 (2005 - $1,332,363) of general and administrative costs relating to exploration and development activities.

FINANCE CHARGES

Financing charges in 2006 totalled $5,996,553 compared to $491,824 in the previous year. This substantial increase arose from the issue of a $60,000,000 unsecured convertible bond in March 2006. Charges are as follows:

- On January 24, 2005, Heritage received a sterling denominated loan of £4.5 million to refinance the acquisition of the technical services office in the United Kingdom. Interest on the loan is fixed at 6.515% for the first five years.

- On March 27, 2006, the Company issued 600 unsecured senior convertible bonds each with a par value of $100,000 for aggregate proceeds of $60,000,000. The bonds bear a coupon rate of 10% per annum and a term of five years and one day. On maturity, any bonds outstanding are redeemed for cash. At the option of the holders, the bonds are convertible,

in whole or in part, into Common Shares at a price of US$18.00 per share at any time during the term of the bonds. The Company may redeem, in whole or part, the bonds for cash at any time on or before March 28, 2007 at 150% of par value. The proceeds on the bonds were bifurcated into a liability component of $56,715,110 and an equity component, representing the conversion feature, of $3,284,890. The difference between the $60,000,000 due on maturity and the initial liability component is accreted and recorded as financing charges. The financing costs of $3,000,000 have been deferred and are being amortized over the term of the bonds. The current carrying value of the liability component is $57,115,731. These convertible bonds were either converted into Common Shares or redeemed in 2007.

FOREIGN EXCHANGE LOSSES

There was a foreign exchange loss in 2006 of $798,194, primarily as a result of the strengthening of sterling against the United States dollar, as the loan secured on the technical services office in London is a sterling-denominated loan. The technical services office in London is not revalued for exchange rate purposes, but acts as a natural hedge against adverse movements in exchange rates with this loan.

The majority of the Company's business is transacted in U.S. dollars and, accordingly, the Company's functional and reporting currency is U.S. dollars.

DEPLETION, DEPRECIATION AND ACCRETION

Depletion, depreciation and accretion expenses increased by $154,918 to $691,011 in 2006. Depletion, depreciation and accretion expenses included depreciation of $176,013 from the Eagle Drill rig, $140,183 higher than the previous year. If this is excluded, depletion, depreciation and accretion expenses in 2006 were in line with the previous year

United States dollars	2006	2005
Depletion, depreciation and accretion	691,011	536,093
Depletion, depreciation and accretion per barrel	11.20	10.52

ASSET RETIREMENT OBLIGATION

The charge for asset retirement obligation is based on production volumes for the period, relative to total proven reserves. It reflects current estimates of abandonment costs for wells and facilities in the areas where the Company is producing.

United States dollars	2006	2005
Balance, beginning of year	434,849	328,553
Additions	62,322	–
Revision	–	80,012
Liabilities divested as part of the Congo disposition	(460,940)	–
Accretion expense, included in depletion and depreciation	26,091	26,284
Balance, end of year	62,322	434,849

GAIN ON DISPOSAL OF DISCONTINUED OPERATIONS

Heritage completed the sale of its interests in the Congo generating a 2006 one-off gain on sale of $9,950,968. All of the disposition agreements were completed in 2006. The gain was calculated after taking into account all relevant costs, including disposal costs and costs in the capitalized cost pool, which totalled $17,820,927. Details of the transactions and consideration were set out in the Operational and Financial Highlights section above.

DISCONTINUED OPERATIONS

The operations of the Kouakouala A and B licenses and Noumbi permit in the Congo have been classified as discontinued operations in 2005 and 2006.

United States dollars	2006	2005
Revenue		
Petroleum and natural gas	**5,116,368**	5,444,936
Interest	**-**	41,361
Other	**645,915**	1,013,010
	5,762,283	6,499,307
Operating Expenses		
Operating	**902,776**	991,956
Royalties	**767,455**	816,740
Foreign exchange losses	**-**	69,623
Depletion, depreciation and accretion	**843,562**	1,099,915
	2,513,793	2,978,234
Discontinued earnings for the year	**3,248,490**	3,521,073

Production from the Kouakouala field, Congo declined from 318 bopd in 2005 to 217 bopd in 2006.

Revenue from the Kouakouala field decreased from $5,444,936 in 2005 to $5,116,368 due to a 29% reduction in sales volumes, offset partly by a 32% increase in average commodity price from $47.53 in 2005 to $62.53 in 2006.

The reduction in revenue resulted in earnings from discontinued operations decreasing from $3,521,073 in 2005 to $3,248,490 in 2006.

COMPANY NET EARNINGS (LOSS) FOR THE YEAR

Earnings totalled $1,336,332 (Cdn$1,558,769) in 2006, compared to a net loss of $3,799,813 (Cdn$4,428,686) in 2005. Net basic and diluted earnings per Common Share were $0.06 (Cdn$0.07) in 2006, compared to a net loss per Common Share of $0.18 (Cdn$0.20) in 2005.

CAPITAL EXPENDITURES

Additions to property, plant and equipment from continuing and discontinued operations were $42,845,579 in 2006 compared to $20,554,465 in 2005. These expenditures may be analyzed by country and category as follows:

United States dollars	2006	2005
Uganda		
Drilling	11,755,148	2,466,385
Seismic	–	1,059,395
Other	1,631,368	2,123,457
	13,386,516	5,649,237
Oman		
Drilling	4,374,975	–
Seismic	572,437	–
Other	951,680	398,316
	5,899,092	398,316
Russia		
Seismic	1,318,498	–
Acquisition of license interest in 2005 and other	11,010,638	6,558,966
	12,329,136	6,558,966
Other		
Undeveloped lands	4,257,783	3,952,033
Eagle Drill rig	851,351	638,613
Corporate	1,272,880	694,899
	6,382,014	5,285,545
Total from continuing operations	37,996,758	17,892,064
Congo (discontinued operations)		
Drilling	1,785,004	1,683,333
Seismic	296,898	–
Other	2,766,919	979,068
	4,848,821	2,662,401
Total capital expenditures	42,845,579	20,554,465

At December 31, 2006, the below new cost centres were considered to be in the preproduction stage and all costs, net of revenues, were capitalized in property, plant and equipment and excluded from costs subject to depletion and depreciation.

United States dollars	2006	2005
Uganda	40,666,311	26,991,888
Russia	22,242,550	9,777,520
Iraq	6,312,777	2,785,419
Democratic Republic of Congo	550,390	464,285
Kazakhstan	–	938,370
Pakistan	1,122,159	416,504
	70,894,187	41,373,986

With the exception of costs in the Kazakhstan cost centre, which have been written-off, management considers there is no impairment to the above costs centres at year-end 2006.

FIXED PRICE CONTRACTS AND DERIVATIVE FINANCIAL INSTRUMENTS

The Company periodically adopts a hedging policy to mitigate certain exposure to commodity pricing risk. No derivative instruments were entered into in 2005 or 2006 or since year-end 2006.

CONTRACTUAL OBLIGATIONS

Heritage's net share of outstanding commitments at year-end 2006 is estimated at:

Payments Due by Period	Total	Less than	1 - 3 years	4 - 5 years	After 5 years
United States dollars (thousands)		1 year			
Long-term debt	8,212	147	294	294	7,477
Convertible bonds	60,000	–	–	60,000	–
Operating leases	9,642	229	458	458	8,497
Work program obligations	16,750	10,000	4,875	1,875	–
Total contractual obligations	94,604	10,376	5,627	62,627	15,974

Work program obligations comprise the estimated costs of minimum work programs set out in certain of the Company's licenses in Russia, Uganda and Oman.

Convertible bonds were either converted into Common Shares or redeemed in 2007 (see Operational and Financial Highlights).

The Company may have a potential residual obligation to satisfy the shortfall in officers' and former officers' secured real estate borrowings in the event of default, a shortfall on the proceeds from the disposal of the properties and the individuals being unable to repay the balance.

On October 6, 2006, the Company terminated Mr. Micael Gulbenkian as its Chairman and Chief Executive Officer. Discussions are on-going with respect to resolution of outstanding matters.

Heritage has not entered into any off balance sheet arrangements that would adversely impact on the Company's financial position or results of operations.

LIQUIDITY & CAPITAL RESOURCES

As at December 31, 2006, the Company had a working capital surplus of $44,419,376 (surplus of $5,650,773 at December 31, 2005). On February 16, 2007, the Company raised US$165,000,000 by completing the private placement of convertible bonds. The Company issued 1,650 unsecured senior convertible bonds, at par, which have a term of five years and one day and an annual coupon of 8.00%. The bonds are convertible into Common Shares at a price of US$47.00 per share. Proceeds were used to finance the redemption of the outstanding $55 million of convertible bonds on March 28, 2007 at a premium of 150% and will be used for general corporate funding purposes.

DEBT

In January 2005, the Company received a sterling denominated loan of £4.5 million to refinance the acquisition of the technical services office at 34 Park Street, Mayfair, London W1K 2JD. Interest on the loan is fixed at 6.515% for the first five years and then is variable at a rate of LIBOR +1.35%. The loan, which is secured on the property, is scheduled to be repaid by 240 instalments of capital and interest at monthly intervals, subject to a residual debt at the end of the term of the loan of $3.5 million (£1,860,000).

On March 27, 2006, the Company issued a $60,000,000 unsecured convertible bond, with a coupon of 10% and a term of five years and one day. The bond was convertible into Common Shares at a price of US$18.00 per share at any time during the term of the bond. The Company may redeem the bond in whole or part at any time during the first 12 months at 150% of par value. On January 17, 2007, the Company gave notice that it had exercised its option to redeem the 550 outstanding unsecured senior convertible bonds at 150% of par value for total proceeds of $82,500,000 plus accrued interest, which was paid on March 28, 2007. A total of 50 of the unsecured convertible bonds, with a total par value of $5,000,000, were converted into Common Shares at an exercise price of US$18.00 per share subsequent to December 31, 2006.

SHARE CAPITAL

During 2006, the Company issued 143,333 Common Shares on the exercise of options. In 2005, the Company issued 546,667 Common Shares on the exercise of options.

Pursuant to the current Normal Course Issuer Bid in place during 2005 and 2006 to November 3, 2006, the Company purchased an aggregate of 135,100 Common Shares under the Normal Course Issue Bid at an average price of $7.85 per share, which were cancelled. No acquisitions were made in 2006.

As at March 29, 2007, there were 22,286,812 Common Shares issued and outstanding and 831,667 options and 1,320,701 stock appreciation units outstanding.

RELATED PARTY TRANSACTION

In 2006, general and administrative expenses included an advisory fee of $1,494,317 (2005 - $877,686) charged by a director of the Company who was appointed CEO on October 6, 2006. In 2005, the Company established a management and finance office in Switzerland that required this director to relocate and he received a relocation allowance of $275,918.

Mr. Atherton, a director of the Company, is also a director of SeaDragon Offshore Limited. The Company acquired 605,000 common shares in SeaDragon Offshore Limited on March 9, 2007 through the sale of its 65% interest in Natural Pipelay Worldwide Limited and Natural Technologies Limited (see Note 14 to the Financial Statements).

SELECTED ANNUAL INFORMATION

	Year ended December 31,		
United States dollars	**2006 (audited)**	2005 (audited)	2004 (audited)
Petroleum and natural gas revenue from continuing operations	3,938,512	841,766	3,288,348
Total petroleum and natural gas revenue(1)	9,054,880	6,286,702	5,592,721
Net earnings (loss) from continuing operations	(11,863,126)	(7,320,886)	672,185
Net earnings (loss) per share from continuing operations (basic & diluted)	(0.54)	(0.33)	0.03
Gain on disposal of discontinued operations	9,950,968	–	26,269,113
Net earnings (loss) for the year	1,336,332	(3,799,813)	28,364,368
Net earnings (loss) per share (basic)	0.06	(0.18)	1.33
Net earnings (loss) per share (diluted)	0.06	(0.18)	1.31
Total assets	160,427,455	86,254,378	80,619,246
Convertible bonds	57,115,731	–	–
Debt	8,557,513	7,768,483	–
Shareholders' equity	79,629,903	71,265,792	73,893,446

Note:

(1) *Before deducting royalties.*

RESULTS FOR FOURTH QUARTER 2006

	Three months ended December 31	
United States dollars	**2006**	2005
Revenue:		
Petroleum and natural gas	**954,421**	110,551
Drilling rig	**404,388**	342,359
Interest	**510,654**	45,756
	1,869,463	498,666
Expenses:		
Petroleum and natural gas operating	**206,743**	73,991
Drilling rig operating	**379,463**	196,804
General and administrative	**4,415,941**	2,651,935
Financing charges	**1,936,721**	133,125
Foreign exchange losses	**281,758**	8,759
Depletion, depreciation and accretion	**179,196**	127,750
Impairment of unproved petroleum and natural gas interests	**986,964**	724,915
	8,386,786	3,917,279
Loss from continuing operations	**(6,517,323)**	(3,418,613)
Gain on disposal of discontinued operations	**9,950,968**	-
Earnings from discontinued operations	**831,175**	555,305
Net earnings (loss) for the fourth quarter	**4,264,820**	(2,863,308)

Production in the fourth quarter averaged 165 bopd, 46% higher than in the same period of the previous year, as analyzed below:

Average net annual production	**2006**	2005
	Bopd	Bopd
Oman		
Condensate	**100**	48
LPG	**65**	65
	165	113

Net production from the Bukha field, Oman increased from 113 bopd in Q4 2005 to 165 bopd in the fourth quarter of 2006. This increase is primarily due to capital costs incurred in 2006 for the West Bukha well being recoverable.

Petroleum and natural gas revenue in the fourth quarter was $952,584, 151% higher than in the same period in the previous year as a result of the periodic nature of condensate sales from inventory in Oman. Revenue may be analysed as follows:

	Three months ended December 31			
	2006	2005	**2006**	2005
United States dollars	$	$	$/bbl[1]	$/bbl[1]
Condensate	**859,037**	-	**57.64**	-
LPG	**93,547**	110,551	**15.54**	18.13
	952,584	110,551	**45.53**	18.13

(1) As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.

General and administrative expenses of $4,415,941 in Q4 2006 were higher than in the same period in the previous year ($2,651,935 in Q4 2005), primarily as a result of higher stock based compensation expense, a series of performance related bonuses to reflect the exploration and development success of the Company in the last 12 months and an increase in the size of the Company's operations. The Company's increased level of activity has yet to result in increased revenues, but significant increases in revenues from growth in production are reasonably expected to occur within the medium term.

Earnings from discontinued operations (Kouakouala A operations) increased from $555,305 in Q4 2005 to $831,175 in Q4 2006, as a result of increased sales volumes in the quarter, following a reduction in sales in the third quarter of 2006.

The fourth quarter 2006 gain on the sale of property, plant and equipment, discussed above, of $9,950,968, was included in the fourth quarter of 2006, which resulted in net earnings for the quarter of $4,264,820 (Cdn$4,974,712) compared to a loss of $2,863,308 (Cdn$3,337,189) in the same period last year. The net earnings (loss) are stated after the impairment provision for unproved interests of $986,964 (Kazakhstan) in Q4 2006 and $724,915 (Nigeria and Turkmenistan) in Q4 2005.

IV. SELECTED QUARTERLY FINANCIAL INFORMATION

Selected quarterly information is summarised below:

United States dollars except for production	2006	2006	2006	2006	2005	2005	2005	2005
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Production (bopd)								
Continuing	165	229	141	146	113	194	126	128
Discontinued	188	186	244	254	278	319	346	346
Total	353	415	385	400	391	513	472	474
Petroleum and natural gas revenue from continuing operations	954,421	1,666,680	85,796	1,231,615	110,551	85,406	561,252	84,557
Total petroleum and natural gas revenue	2,265,284	2,120,735	2,036,008	2,632,853	1,297,072	1,809,630	1,729,613	1,450,387
Loss from continuing operations	(6,517,323)	(2,007,968)	(2,945,756)	(392,080)	(3,418,612)	(1,145,922)	(1,403,869)	(1,352,482)
Loss per share from continuing operations – basic & diluted	(0.30)	(0.09)	(0.13)	(0.02)	(0.16)	(0.05)	(0.07)	(0.06)
Discontinued operations earnings	831,175	326,239	1,264,829	826,248	555,305	1,342,442	708,372	914,954
Net earnings (loss)	4,264,820	(1,681,729)	(1,680,927)	434,168	(2,863,308)	196,520	(695,497)	(437,528)
Net earnings (loss) per share – basic & diluted	0.19	(0.08)	(0.08)	0.02	(0.14)	0.01	(0.03)	(0.02)
Total capital expenditures	19,440,271	11,115,519	8,308,997	3,980,792	8,750,613	3,400,271	5,276,949	3,126,632
Common Shares outstanding	22,009,034	21,925,701	21,925,701	21,865,701	21,865,701	21,815,701	21,780,101	21,428,534

TRADING RANGE OF COMMON SHARES

Canadian dollars				
2006	High	Low	Close	Volume
Fourth Quarter	30.75	16.52	30.75	2,278,100
Third Quarter	18.25	15.11	17.25	1,049,417
Second Quarter	19.00	14.75	17.28	1,580,547
First Quarter	15.39	10.12	15.00	2,221,430
2005				
Fourth Quarter	17.04	8.05	14.45	2,911,997
Third Quarter	15.25	8.10	15.00	4,639,513
Second Quarter	9.85	6.36	9.00	2,900,025
First Quarter	9.19	7.02	7.98	1,597,490

2004				
Fourth Quarter	9.40	5.60	8.65	2,113,036
Third Quarter	7.00	4.70	6.66	1,406,034
Second Quarter	5.35	3.44	4.70	1,287,750
First Quarter	5.10	2.70	4.25	2,662,478

- Record share prices, with a high of Cdn$38.00 per share, were reached during the first quarter of 2007.
- A 113% increase in share price in 2006 between January 1, 2006 and December 31, 2006.

V. OUTLOOK FOR 2007

The Company's business plan for 2007 includes the following appraisal, development and exploration programs:

- **Russia**

  The drilling of three exploration wells to fulfill the license commitment, the re-entry of an existing well and the continuous drilling of production wells.

- **Sultanate of Oman**

  Development of the West Bukha field continues, including design, fabrication and installation of the wellhead platform and pipeline so that production can commence in the first half of 2008.

- **Uganda**

  Two seismic surveys will be shot in 2007; an approximately 325 square kilometre 3D program over the Kingfisher and Pelican structures in Block 3A and an approximately 500 kilometre 2D survey in Block 1. Further drilling of the Kingfisher prospect will commence following the acquisition and interpretation of the 3D seismic survey. Efforts are currently being made to identify and secure a higher capacity rig capable of deeper drilling in order to explore the deepest objectives in the Albert Basin towards the end of 2007.

- **DRC**

  The acquisition of a seismic survey over the lake parts of Blocks I and II is being considered once the Presidential Decree has been awarded.

- **Kurdistan**

  Heritage is pursuing opportunities in the Kurdistan region of Iraq. An office was opened in 2005 and fieldwork commenced in 2006. Discussions are underway with the Ministry of Natural Resources of Kurdistan to be awarded a production sharing agreement, following which an exploration program will commence.

Production in 2007 is estimated in the RPS Energy Report as follows:

	Average forecast production
	Bopd
Oman - Bukha Field	106
Russia - West Chumpass	932
	1,038

The above estimates assume no delays are experienced in work programs. The RPS Energy report assumes Heritage spends $50.5 million in 2007 developing its proved and probable reserves.

Russia

Heritage re-entered the existing well #226 in the West Chumpass field in December 2006, which under preliminary free-flow test produced 124 barrels of oil over a five hour period, with no water, at a flowing wellhead pressure of 1,180 psi. This corresponds to some 600 bopd. Heritage acquired a 95% equity interest in the West Chumpass field in 2005. This field was discovered in 1997. A total of nine wells were drilled on the license prior to Heritage's acquisition.

Heritage intends to establish early production this year from this re-entry of an existing well bore and to fast-track the development of the field. Commercial production from the field is expected to commence in April 2007, increasing to an estimated peak of approximately 18,000 bopd in 2012. Total gross development costs of the field are estimated by RPS Energy at approaching $300 million and are estimated to be incurred up to 2011, with peak expenditure expected in 2007 and 2008. On production test in December 2006, the reservoir flowed approximately 600 bopd per well.

Sultanate of Oman

Condensate and LPG production from the Bukha field, Oman is expected to continue to decline from this mature field.

Production from the West Bukha field, Oman is expected to commence in the first half of 2008.

Heritage is in negotiation with a number of governments and entities in certain of its core areas (the Middle East, Russia and Africa) for the purchase of additional attractive assets, and is focusing on opportunities that have the potential to increase shareholder value by increasing the Company's reserve base and production.

The Company's operational results and financial condition will be dependent on the prices received for oil and natural gas production. Oil and natural gas prices have fluctuated widely during recent years and are determined by demand and supply factors, including weather and general economic conditions, as well as conditions in other oil and natural gas regions.

VI. CRITICAL ACCOUNTING ESTIMATES

The notes to the financial statements outline Heritage's significant accounting policies. The policies discussed below are considered particularly important, as they require management to make significant judgments, estimates and assumptions some of which may relate to matters that are inherently uncertain. A summary of the Company's significant accounting policies can be found in Note 1 to the consolidated financial statements. The following is a discussion of those accounting policies and estimates that are considered critical in the determination of the Company's financial results.

FINANCIAL ESTIMATES AND USE OF ESTIMATES

The consolidated financial statements of the Company have been prepared by management in accordance with accounting principles generally accepted in Canada. In preparing financial statements, management makes informed judgments and estimates that affect the reported amounts of assets and liabilities as of the date of the financial statements and affect the reported amounts of revenues and expenses during the reported period. Actual results will differ from these estimates.

ACCOUNTING FOR OIL AND GAS OPERATIONS

The Company follows the full cost method of accounting for petroleum and natural gas operations, whereby all costs related to the acquisition, exploration and development of petroleum and natural gas interests are accumulated within cost centres on a country-by-country basis.

Proceeds from the sale of petroleum and natural gas interests are applied against capitalized costs except for sales that would change the rate of depletion and depreciation by 20% or more, in which case a gain or loss is recorded.

Capitalized costs, together with estimated future capital costs associated with proved reserves, are depleted and depreciated using the unit of production method based on estimated gross proved reserves of petroleum and natural gas as determined by independent engineers. Costs of acquiring and evaluating significant unproved petroleum and natural gas interests are excluded from costs subject to depletion and depreciation until it is determined that proved reserves are attributable to such interest or until impairment occurs.

A revision to the estimate for proved reserves can have a significant impact on earnings as they are a key component in the calculation of depreciation, depletion and accretion.

An impairment loss is recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of the undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Undeveloped lands are assessed quarterly to determine whether impairment has occurred. Where interests are considered impaired the cost of the property or the amount of impairment is included in costs subject to depletion and the ceiling test.

A substantial portion of the Company's African and Oman exploration and development activities are conducted jointly with others. The financial statements reflect only the Company's proportionate interests in such activities.

NEW ACCOUNTING PRONOUNCEMENTS

Financial Instrument - Recognition and Measurement, Hedging and Comprehensive Income

In January 2005, the Canadian Institute of Chartered Accountants ("CICA") released the new Handbook Section 3855, "Financial Instruments – Recognition and Measurement" and Section 1530, "Comprehensive Income", effective for the interim periods and year ends for fiscal years commencing on or after January 1, 2007 on a prospective basis.

The Company will adopt these new standards starting on January 1, 2007 on a prospective basis.

Section 3855 establishes standards for the recognition and measurement of all financial instruments, provides a characteristics-based definition of a derivative financial instrument, provides criteria to be used to determine when a financial instrument should be recognized, and provides criteria to be used when a financial instrument is to be extinguished. Section 1530 establishes standards for reporting comprehensive income. These standards require that an enterprise presents comprehensive income and its components in a separate financial statement that is displayed with the same prominence as other financial statements.

The Company anticipates the adoption of these new standards will have a minimal impact on the Company.

At December 31, 2006 the Company is not a counter-party to any derivative contracts nor does it believe that it has any embedded derivatives. Should the Company enter into any such contracts in the future it will account for them under these new standards.

FINANCIAL INSTRUMENTS - DISCLOSURE

In December 2006, the AcSB issued Section 3862 as a new accounting standard on disclosures about financial instruments. Section 3862 must be implemented no later than the first reporting period in the first fiscal year beginning on or after October 1, 2007.

Section 3862 places an increased emphasis on disclosures about the risks associated with both recognized and unrecognized financial instruments and how those risks are managed.

The additional disclosures will be evaluated by the Company.

ACCOUNTING CHANGES

In July 2006 the CICA issued revised Section 1506, Accounting Changes. The main features are as follows:

- Voluntary changes in accounting policy are made only if they result in the financial statements providing reliable and more relevant information.
- Changes in accounting policy are applied retrospectively unless doing so is impracticable.
- Prior period errors are corrected retrospectively.
- New disclosures are required in respect of changes in accounting policies, changes in accounting estimates and correction of errors.

The revised Section applies to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2007. The requirements of this new section will be addressed as circumstances dictate.

CAPITAL DISCLOSURES

In December 2006, the CICA issued a new accounting standard on disclosures about capital. Section 1535, Capital Disclosures, must be implemented no later than the first reporting period in the first fiscal year beginning on or after October 1, 2007. Section 1535 requires an entity to disclose information about its objectives, policies and processes for managing capital, as well as its compliance with any externally imposed capital requirements. The Section requires entities to describe and provide quantitative data about what they manage as capital. The Company is analyzing the additional disclosure requirements and will address these issues at or on October 1, 2007.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

Within the next five years, Canadian generally accepted accounting principles for publicly accountable enterprises are expected to be replaced with International Financial Reporting Standards (IFRSs). The CICA anticipates a five-year transition period (ending around 2011). The Company will address the impact of the adoption of IFRSs as and when the transition requirements become more clearly defined. It is possible that the adoption of IFRS will have a material impact on the Company's financial statements.

DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosures. The Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") have concluded, based on their evaluation as of the end of the period covered by this MD&A, that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the Company, including its consolidated subsidiaries, is made known to them by others within those entities. It should be noted that while the Company's CEO and CFO believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

VII. INTERNAL CONTROLS OVER FINANCIAL REPORTING

Multilateral Instrument 52-109 of the Canadian Securities Administrators defines internal controls over financial reporting as "a process designed by, or under the supervision of the issuer's chief executive officers and chief financial officers or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP and includes those policies and procedures that:

a) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer.

b) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the issuer's GAAP, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer.

c) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the annual financial statements or interim financial statements."

The Company has, under the supervision of its Chief Executive Officer and Chief Financial Officer, designed a process for internal control over financial reporting, which process has been effected by the Company's board of directors and management. The process was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the Company's GAAP and incorporates policies and procedures as described above.

Given the size of the Company, the evaluation of the design of internal controls over financial reporting for the Company resulted in the identification of the following weaknesses:

1) Management is aware that due to its relatively small scale of operations there is a lack of segregation of duties due to a limited number of employees dealing with accounting and financial matters. However, management has concluded that considering the employees involved and the control procedures in place, including management and Audit Committee oversight, risks associated with such lack of segregation are not significant enough to justify the expense associated with adding employees to clearly segregate duties.

2) As part of its business, the Company records complex and non-routine transactions. These transactions can be very technical in nature and the determination of the appropriate accounting for these transactions requires an in-depth understanding of Canadian GAAP. The Corporation's accounting staff has a fair and reasonable knowledge of the rules related to Canadian GAAP and reporting of the transactions may not be recorded correctly, potentially resulting in a material misstatement of the consolidated financial statements of the Company.

To address this risk, the Company consults with third party expert advisors on a regular basis for advice and seeks specific advice on proposed or contemplated transactions. The Company would have to considerably increase its size and the scope of its activities before the Company could contemplate having dedicated in-house resources with the required knowledge of all aspects of Canadian GAAP that may impact on the complex and non-routine transactions that the Company may enter into.

There have been no significant changes to the Company's internal control over financial reporting that occurred during the most recent period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

VIII. BUSINESS RISKS AND UNCERTAINTY

The Company is exposed to a number of risks and uncertainties inherent in exploring for, developing and producing crude oil and natural gas. These risks and uncertainties include, but are not limited to those discussed below.

The international energy business is subject to risks in exploration, development and production activities. These activities can expose the Company to risks of destruction of assets, well blowouts and other operational events. Heritage has purchased certain liability insurance to protect its international assets and activities from such risks where it is considered appropriate.

The Company has very limited control over external factors such as oil and gas prices, foreign exchange rates and government regulations. Where appropriate, the Company manages commodity price risks by using commodity hedging programs that have the primary goal of minimizing significant downward movements in commodity prices.

The international petroleum sector is very competitive and the Company is thus in competition with many other participants in the search for and acquisition of suitable properties, the marketing of oil and gas production, as well as developing successful partnership groups and accessing appropriately priced sources of additional capital.

The Company operates in various developing countries, some of which have historically experienced periods of civil and political unrest and economic instability. Heritage's properties are located in relatively remote areas, some of which are difficult to access.

There can be no assurances that future instability within such countries, or actions by other companies, host governments, or the international community may not have a material adverse effect.

Products are transported to markets by third parties and closure of facilities or pipelines may occur over which the Company has little control.

As is common throughout the industry, the Company's operations are environmentally sensitive and spills and other damage can occur for which the Company and its partners are liable for reclamation costs. Environmental regulation which imposes, among other things, restrictions, liabilities and obligations in connection with water and air pollution control, waste management, permitting requirements and restrictions on operations in environmentally sensitive areas may change which could have an impact on the Company's operations. The Company believes that it follows best international oil field practices in this area. Insurance may also be obtained to cover certain aspects.

There are a number of uncertainties inherent in estimating the quantities of oil and natural gas reserves. Reservoir engineering is a subjective process of estimating underground accumulations that cannot be measured precisely, and the accuracy of any estimate is a function of the quality of available data and of engineering, geological interpretation and judgment. Heritage's reserves are evaluated by an independent reservoir engineering firm on an annual basis in accordance with applicable regulations.

The ability to retain current employees or to attract and retain new key employees is required for the Company to sustain future growth.

There could be increased competition from alternative forms of energy, fuel and related products that could have a material adverse effect on the Company's business, prospects and results of operations.

Heritage holds rights to explore its various oil and gas properties, but no assurance can be given that applicable governments will not revoke, or significantly alter the conditions of, the applicable exploration and development authorizations and that such exploration and development authorizations will not be challenged or impugned by third parties. There is no certainty that such rights or additional rights applied for will be granted or renewed on terms satisfactory to Heritage. There can be no assurance that claims by third parties against the Company's properties will not be asserted at a future date.

The Company's future success is dependent on its ability to find or acquire additional reserves that are economically recoverable and securing sufficient capital to undertake the operations. Without successful exploration and development activities, the reserves of the Company will decline, which could impact operating cash flows and results of operations. This risk may be managed by using strict economic criteria for new projects and retaining highly-skilled, knowledgeable personnel in all phases of oil operations.

In addition to the foregoing risks, readers are directed to the section entitled, "Risk Factors" in the Company's AIF.

ENVIRONMENTAL, HEALTH AND SAFETY

Heritage is committed to conducting its activities in an environmentally responsible manner, protecting the health and safety of its employees and the public in every country in which it operates. Heritage personnel work safely and in accordance with established regulations and procedures. Heritage strives to improve areas of environment, health and safety performance, working with local communities in order to:

- Reduce long-term environmental liabilities through decommissioning, abandoning and reclaiming well leases and facilities.
- Monitor long-term liabilities through regular inspections.
- Minimize and reduce flaring and greenhouse gas emissions.
- Minimize waste products by reducing, recycling and recovering.

CORPORATE GOVERNANCE

Heritage is committed to a high standard of corporate governance practices. The Company believes good corporate governance is in the best interest of shareholders and successful companies deliver growth and a competitive return alongside a commitment to the environment, to the communities where they operate and to their employees.

Heritage complies with the objectives and guidelines relating to corporate governance adopted by the Toronto Stock Exchange. In addition, the Board monitors and considers the implementation of corporate governance standards proposed by various regulatory and non-regulatory authorities in Canada. A full examination of the Company's corporate governance policies will be provided in the information circular to be provided for the annual general meeting, which will be filed on SEDAR (www.sedar.com) in due course.

March 29, 2007

DRILLING ACTIVITIES AT THE KINGFISHER SITE IN BLOCK 3A UGANDA

Photograph courtesy of Norman Childs, Greenshoots Communications

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Heritage Oil Corporation as at December 31, 2006 and 2005 and the consolidated statements of earnings (loss) and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants
Calgary, Canada
March 29, 2007
heritage oil corporation

CONSOLIDATED BALANCE SHEETS

December 31, 2006 and 2005		
(U.S. Dollars)	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$ 46,861,146	$ 8,583,321
Accounts receivable	9,839,506	580,664
Inventories	50,552	193,361
Prepaid expenses	531,273	219,222
Assets of discontinued operations (note 2)	–	760,899
	57,282,477	10,337,467
Property, plant and equipment (note 3)	98,311,833	61,053,053
Deferred financing fees (note 4)	2,539,726	–
Investment in warrants (note 2)	719,380	–
Deferred development costs	1,574,039	1,187,371
Assets of discontinued operations (note 2)	–	13,676,487
	$ 160,427,455	$ 86,254,378
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 12,715,381	$ 4,438,649
Current portion of long-term debt (note 5)	147,720	248,045
	12,863,101	4,686,694
Long-term debt (note 5)	8,409,793	7,520,438
Convertible bonds (note 4)	57,115,731	–
Asset retirement obligations (note 7)	62,322	–
Future income tax liability (note 9)	2,346,605	2,346,605
Liabilities of discontinued operations (note 2, 7)	–	434,849
Shareholders' equity:		
Share capital (note 8(b))	24,580,984	22,854,418
Contributed surplus (note 8(h))	2,533,532	517,209
Convertible bonds equity component (note 4)	3,284,890	–
Retained earnings	49,230,497	47,894,165
	79,629,903	71,265,792
Commitments and contingencies (note 13)		
Subsequent events (note 14)		
	$ 160,427,455	$ 86,254,378

See accompanying notes to consolidated financial statements.

On Behalf of the Board

Director

Director

CONSOLIDATED STATEMENTS OF EARNINGS (LOSS) AND RETAINED EARNINGS

Years ended December 31, 2006 and 2005	Twelve months ended	
(U.S. Dollars)	**2006**	2005
Revenue:		
Petroleum and natural gas	$ **3,938,512**	$ 841,766
Drill rig	**2,895,727**	342,359
Interest	**1,767,898**	330,290
	8,602,137	1,514,415
Expenses:		
Petroleum and natural gas operating	**723,611**	465,110
Drilling rig operating	**2,291,585**	196,804
General and administrative	**8,977,345**	5,249,649
Financing charges (note 6)	**5,996,553**	491,824
Foreign exchange losses	**798,194**	1,170,906
Depletion, depreciation and accretion	**691,011**	536,093
Impairment of unproved petroleum and natural gas interest (note 3)	**986,964**	724,915
	20,465,263	8,835,301
Loss from continuing operations	**(11,863,126)**	(7,320,886)
Gain on disposal of discontinued operations	**9,950,968**	–
Earnings from discontinued operations (note 2)	**3,248,490**	3,521,073
Net earnings (loss)	**1,336,332**	(3,799,813)
Retained earnings, beginning of year	**47,894,165**	52,434,857
Premium on purchase and cancellation of Common Shares (note 8(e))	**–**	(740,879)
Retained earnings, end of year	$ **49,230,497**	$ 47,894,165
Net loss per share from continuing operations (note 8(f)):		
Basic and diluted	$ **(0.54)**	$ (0.33)
Net earnings (loss) per share (note 8(f)):		
Basic and diluted	$ **0.06**	$ (0.18)

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOW

Years ended December 31, 2006 and 2005 (U.S. Dollars)	2006	2005
Cash provided by (used in):		
Operating:		
Net loss from continuing operations	$ (11,863,126)	$ (7,320,886)
Items not involving cash:		
Depletion, depreciation and accretion	691,011	536,093
Financing charges	860,895	–
Foreign exchange losses	593,837	480,253
Stock-based compensation	1,483,945	625,365
Impairment of unproved petroleum and natural gas interests (note 3)	986,964	724,915
Changes in non-cash operating working capital	(415,755)	1,617,348
	(7,662,229)	(3,336,912)
Discontinued operations (note 2):		
Earnings from discontinued operations	3,248,490	3,521,073
Depletion, depreciation and accretion	843,562	1,099,915
Change in non-cash operating working capital	(343,199)	(586,953)
	(3,913,376)	697,123
Financing:		
Common Shares issued for cash	1,318,945	1,423,011
Convertible bonds, net of issue costs	57,000,000	–
Long-term debt	–	8,577,350
Purchase of Common Shares for cancellation	–	(876,217)
Repayment of long-term debt	(287,759)	(103,997)
	58,031,186	9,020,147
Investing:		
Property, plant and equipment expenditures	(37,996,758)	(17,863,537)
Development expenditures	(386,668)	(174,359)
Change in non-cash investing working capital	4,484,371	1,573,765
	(33,899,055)	(16,464,131)
Discontinued operations (note 2):		
Proceeds from the disposal of discontinued operations	27,052,515	–
Discontinued operations - repayment of note receivable	–	4,210,538
Discontinued operations property, plant and equipment expenditures	(4,848,821)	(2,690,928)
Changes in non-cash investing working capital of discontinued operations	(4,627,578)	(1,239,828)
	(16,322,939)	(16,184,349)
Foreign exchange gains (losses) on cash held in foreign currency	482,954	(1,185,123)
Increase (decrease) in cash and cash equivalents	38,277,825	(7,652,202)
Cash and cash equivalents, beginning of year	8,583,321	16,235,523
Cash and cash equivalents, end of year	$ 46,861,146	$ 8,583,321
Supplementary information:		
Interest received	$ 1,665,998	$ 397,640
Interest paid	$ 5,032,919	$ 491,824

See accompanying notes to consolidated financial statements.

Years ended December 31, 2006 and 2005

(U.S. dollars)

Heritage Oil Corporation (the "Corporation") is incorporated under the Business Corporations Act (Alberta) and its primary business activity is the exploration, development and production of petroleum and natural gas in Africa, Russia, South Asia and the Middle East.

The preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

1. Significant accounting policies:

(a) Basis of presentation:

The consolidated financial statements include the accounts of the Corporation, its subsidiaries and its proportionate interests in corporate joint ventures.

The majority of the Corporation's business is transacted in U.S. dollars and, accordingly, the Corporation's functional and reporting currency is U.S. dollars.

(b) Joint operations:

The majority of exploration, development and production activities are conducted jointly with others and accordingly, the Corporation only reflects its proportionate interest in such activities.

(c) Cash and cash equivalents:

The Corporation considers deposits in banks, certificates of deposit and short-term investments with original maturities of three months or less as cash and cash equivalents.

(d) Inventories:

Inventories consist of petroleum, condensate, liquid petroleum gas and materials that are recorded at the lower of average cost and net realizable value.

(e) Property, plant and equipment:

The Corporation follows the full cost method of accounting for petroleum and natural gas operations, whereby all costs related to the acquisition, exploration and development of petroleum and natural gas interests are accumulated within cost centres on a country-by-country basis. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing interests, costs of drilling both productive and non-productive wells, major development projects and overhead charges directly relating to acquisition, exploration and development activities.

Proceeds from the sale of petroleum and natural gas interests are applied against capitalized costs except for sales that would change the rate of depletion and depreciation by 20% or more, in which case a gain or loss is recorded.

Capitalized costs, together with estimated future development and retirement costs associated with proved reserves, are depleted using the unit of production method based on estimated gross proved reserves of petroleum and natural gas as determined by independent engineers. For purposes of this calculation, reserves and production are converted to equivalent units of petroleum based on relative energy content of six thousand cubic feet of natural gas to one barrel of petroleum.

Costs of acquiring and evaluating significant unproved petroleum and natural gas interests are excluded from costs subject to depletion and depreciation until it is determined that proved reserves are attributable to such interest or until impairment occurs.

(e) Property, plant and equipment (continued):

The full cost method of accounting for oil and gas activities requires a detailed impairment calculation when events or circumstances indicate a potential impairment of the carrying amount of oil and gas assets may have occurred, but at least annually.

An impairment loss is recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of the undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Drilling rig equipment is depreciated using the unit-of-production method based on 2,740 drilling days with a 20% salvage value.

Corporate capital assets are amortized on a straight-line basis over their estimated useful lives. The building is amortized on a straight-line basis over 40 years.

(f) Asset retirement obligations:

The Corporation records the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. Subsequent to the initial measurement of the asset retirement obligations, the obligations are adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation.

(g) Deferred development costs:

Development costs related to specific projects that in the Corporation's view have a clearly defined future market are deferred and amortized on a straight line basis commencing in the year following that in which the new product development was completed. All other research and development costs are charged to earnings in the year incurred.

(h) Revenue recognition:

Revenues from the sale of petroleum and natural gas are recorded when title passes to an external party.

(i) Income taxes:

The Corporation uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

(j) Foreign currency translation:

All of the Corporation's operations are considered as integrated and have U.S. dollar as functional currency.

Accordingly, all monetary items denominated in foreign currencies are translated to U.S. dollars at exchange rates in effect at the balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expenses are translated at rates in effect at the time of the transactions. Foreign exchange gains and losses are included in earnings.

1. Significant accounting policies (continued):

(k) Stock based compensation plans:

The Corporation applies the fair value method of accounting to all equity-classified stock-based compensation arrangements for both employees and non-employees. Compensation cost of equity-classified awards to employees are measured at fair value at the grant date and recognized over their vesting period with a corresponding increase to contributed surplus. Compensation cost of equity-classified awards to non-employees are initially measured at fair value, and periodically remeasured to fair value until the non-employees' performance is complete, and recognized over their vesting period with a corresponding increase to contributed surplus. Upon the exercise of the award, consideration received together with the amount previously recognized in contributed surplus is recorded as an increase to share capital.

The Corporation applied the intrinsic value method of accounting to all liability-classified stock-based compensation arrangement for both employees and non-employees. Compensation cost of liability-classified awards are measured at intrinsic value each balance sheet date and recognized over their vesting period with a corresponding increase to a liability. After vesting is complete, changes in intrinsic value are recognized in the period they occur.

The Corporation accounts for forfeitures as they occur.

(l) Per share amounts:

Basic earnings per share are computed by dividing net earnings (loss) by the weighted average shares outstanding during the year. Diluted per share amounts are calculated using the treasury stock and if-converted methods. The treasury stock method increases the diluted weighted average shares outstanding to include additional shares from the assumed exercise of stock options and warrants, if dilutive. The number of additional shares is calculated by assuming that outstanding in-the-money stock options were exercised and that the proceeds from such exercises, including the unamortized stock-based compensation cost, were used to acquire shares of common stock at the average market price during the year. The if-converted method assumes the conversion of convertible securities at the latter of the beginning of the reported period or issuance date, if dilutive.

(m) Measurement uncertainty:

The amounts recorded for depletion and depreciation of petroleum and natural gas interests and the provision for asset retirement obligation costs are based on estimates. The ceiling test is based on estimates of proved and probable reserves, production rates, petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes in such estimates in future periods could be significant.

(n) Comparative figures:

Certain prior year balances have been reclassified to conform to the current year's presentation.

2. Discontinued operations:

On June 6, 2006, the Corporation entered into an agreement to sell Heritage Congo Limited which held all of the Corporation's interests in the Noumbi Exploration Permit and the Kouakouala A and B licenses in the Republic of Congo ("Congo") to Afren PLC, subject to a number of conditions precedent and pre-emption rights. The Corporation's partners in the Kouakouala A and B licenses exercised pre-emption right in respect of the sale of these assets. Accordingly, the Corporation sold these assets to three separate public entities in 2006.

On November 22, 2006, the Corporation completed the sale of Heritage Congo Limited, which held a 14% working interest in the Noumbi Exploration Permit, to Afren PLC ("Afren") for the following consideration:

(i) Cash of US$21,000,000, which has been received; and

(ii) 1,500,000 Afren warrants, with a term of five years and an exercise price of £0.60 GBP Sterling per share. The fair value of the Afren warrants determined by the Black-Scholes model was $719,380.

On January 18, 2007, the Corporation finalized the statement of adjustments relating to the sale of its 25% working interest in the Kouakouala A and 30% working interest in the Kouakouala B license in Congo to the other partners in the licenses, Maurel et Prom and Burren Energy, for the following consideration:

(i) Cash of US$6,052,515, which has been received; and

(ii) An overriding royalty of 15% over a 30% working interest in the Kouakouala B license in relation to the Mengo Field. The Mengo Field is not in production.

All of the disposition agreements were completed in 2006. The gain on disposition of all of the Corporation's interests in the Congo was $9,950,968 in 2006. As at December 31, 2006 accounts receivable included $5,157,646 relating to the unpaid portion of the sales proceeds which was received in January 2007.

The results of operations in Congo have been classified as results of discontinued operations. The following table provides additional information with respect to the amounts included in the results of discontinued operations.

	Period ended December 12, 2006	Year ended December 31, 2005
Revenue		
Petroleum and natural gas	$ 5,116,368	$ 5,444,936
Interest	-	41,361
Other	645,915	1,013,010
	5,762,283	6,499,307
Expenses		
Operating	902,776	991,956
Royalties	767,455	816,740
Foreign exchange losses	-	69,623
Depletion, depreciation and accretion	843,562	1,099,915
	2,513,793	2,978,234
Discontinued operations	$ 3,248,490	$ 3,521,073

The following table provides additional information with respect to the amounts included in the Balance Sheet as assets held for sale and associated liabilities.

	December 31, 2005
Assets	
Current	
Accounts receivable	$ 737,786
Inventories	23,113
	760,899
Property, plant and equipment	13,676,487
	$ 14,437,386
Liabilities	
Asset retirement obligation	$ 434,849
	$ 434,849

3. Property, plant and equipment:

		2006		2005
Petroleum and natural gas interests and equipment	$	96,090,796	$	60,748,657
Drilling equipment		3,544,969		2,693,618
Land and building		11,984,701		11,984,701
Other		2,687,590		931,289
		114,308,056		76,358,265
Accumulated depletion and depreciation		(15,996,223)		(15,305,212)
	$	98,311,833	$	61,053,053

A ceiling test was undertaken at December 31, 2006 to determine whether there was an impairment to cost centres with proved reserves. In undertaking the ceiling test the following forecast prices were used:

		Oman						Russia		
		Condensate		Saudi Export		Bukha		West Bukha	Urals Export	
	Brent	NWS	Bukha	Propane	Butane	Propane	Butane	Gas	Blend	Domestic
Year	$/bbl	$/bbl	$/bbl	$/tonne	$/tonne	$/tonne	$/tonne	$/MMBTU	$/bbl	$/bbl
2007	57.99	56.77	54.07	470.36	476.89	376.29	381.51	1.00	53.84	27.16
2008	60.37	59.02	56.32	483.21	489.44	386.57	391.55	1.00	56.02	28.28
2009	58.88	57.60	54.90	475.14	481.55	380.11	385.24	1.00	54.65	27.58
2010	56.87	55.70	53.00	464.33	470.99	371.46	376.79	1.00	52.81	26.64
2011	55.08	54.01	51.31	454.71	461.59	363.77	369.27	1.00	51.17	25.80
2012	54.75	53.70	51.00	452.91	459.84	362.33	367.87	1.00	50.86	25.65
2013	54.38	53.35	50.65	450.92	457.89	360.74	366.31	1.00	50.52	25.47
2014	55.47	54.38	51.68	456.78	463.62	365.43	370.90	1.00	51.52	25.98
2015+	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	+2% pa	1.00	+2% pa	+2% pa

At December 31, 2006, the below new cost centres were considered to be in the preproduction stage and all costs, net of revenues, were capitalized in property, plant and equipment and excluded from costs subject to depletion and depreciation.

		2006		2005
Uganda	$	40,666,311	$	26,991,888
Russia		22,242,550		9,777,520
Iraq		6,312,777		2,785,419
Democratic Republic of Congo		550,390		464,285
Kazakhstan		–		938,370
Pakistan		1,122,159		416,504
	$	70,894,187	$	41,373,986

The costs held in the Russia new cost centre relate to the proved undeveloped reserves.

Major uncertainties affect the recoverability of these costs as the recovery of the costs outlined above is dependent on the Corporation obtaining licenses in certain instances, discovery of adequate commercial reserves and achieving commercial production or sale.

At December 31, 2006, the cost of unproved petroleum and natural gas interests of $6,889,019 (2005 - $11,727,768) for cost centres that are no longer in the preproduction stage have also been excluded from costs subject to depletion and depreciation.

In 2006, the Corporation capitalized $2,813,303 (2005 - $1,332,363) of general and administrative costs relating to exploration and development activities.

Unproved interests are assessed quarterly to determine whether impairment has occurred. In the fourth quarter of 2006, the Corporation wrote-off all of the costs held in the Kazakhstan new cost centre of $986,964 (2005 - $724,915 relating to all of the costs held in the Nigeria and Turkmenistan cost centres).

4. *Convertible bonds:*

On March 27, 2006, the Corporation issued 600 unsecured senior convertible bonds each with a par value of $100,000 for aggregate proceeds of $60,000,000. The bonds bear a coupon rate of 10% per annum and a term of five years and one day. On maturity, any bonds outstanding are redeemed for cash. At the option of the holders, the bonds are convertible, in whole or in part, into Common Shares at a price of US$18.00 per share at any time during the term of the bonds. The Corporation may redeem, in whole or part, the bonds for cash at any time on or before March 28, 2007 at 150% of par value. Pursuant to the bond agreement, the Corporation is required to maintain an equity to debt, net of cash and cash equivalent, ratio of no less than 0.65:1.00. The proceeds of the bond can be employed for development of the West Chumpass field in Russia and for general corporate purposes.

The proceeds on the bonds were bifurcated into a liability component of $56,715,110 and an equity component, representing the conversion feature, of $3,284,890. The difference between the $60,000,000 due on maturity and the initial liability component is accreted and recorded as financing charges. The financing costs of $3,000,000 have been deferred and are being amortized over the term of the bonds. The current carrying value of the liability component is $57,115,731.

Convertible bonds were either converted into Common Shares or redeemed in 2007 (note 14).

5. *Long-term debt:*

In January 2005, a wholly-owned subsidiary of the Corporation received a sterling denominated loan of £4.5 million to refinance the acquisition of a corporate office. Interest on the loan is fixed at 6.515% for the first five years and then is variable at a rate of London Interbank Offered Rate ("LIBOR") plus 1.35%. The loan, which is secured on the property, is scheduled to be repaid by 240 instalments of capital and interest at monthly intervals, subject to a residual debt at the end of the term of the loan of $3.5 million (£1,860,000). The current principal balance outstanding as at December 31, 2006 was $8,557,513 (£4.4 million).

6. Financing charges:

	2006	2005
Interest on long-term debt	$ 532,918	$ 491,824
Interest on convertible bond	4,602,740	–
Amortisation of financing fees	460,274	–
Accretion of convertible debt	400,621	–
	$ 5,996,553	$ 491,824

7. Asset retirement obligations:

The Corporation's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites and gathering systems. The Corporation estimates the total undiscounted inflation-adjusted amount of cash flows required to settle its asset retirement obligations is approximately $100,370, which is expected to be incurred in 2010. A credit-adjusted risk-free rate of 10% was used to calculate the fair value of the asset retirement obligations in 2006 (2005 – 8%).

A reconciliation of the asset retirement obligations is provided below:

	2006	2005
Balance, beginning of year	$ 434,849	$ 328,553
Additions	62,322	–
Revisions	–	80,012
Liabilities divested as part of the Congo disposition (note 2)	(460,940)	–
Accretion expense, included in depletion and depreciation	26,091	26,284
Balance, end of year	$ 62,322	$ 434,849

8. Share capital:

(a) Authorized:

Unlimited number of Common Shares without par value

(b) Issued:

	2006		2005	
	Number	US$ Amount	Number	US$ Amount
Common Shares				
Balance, beginning of year	21,865,701	$ 22,854,418	21,454,134	$ 21,434,168
Issued on exercise of stock options (c)	143,333	1,726,566	546,667	1,555,588
Normal course issuer bid program (e)	–	–	(135,100)	(135,338)
Balance, end of year	22,009,034	$ 24,580,984	21,865,701	$ 22,854,418

(c) Stock options:

The Corporation has a stock option plan whereby certain directors, officers, employees and consultants of the Corporation may be granted options to purchase Common Shares. Under the terms of the plan, options granted normally vest one third immediately and one third in each of the years following the date granted and have a life of five years.

Common Share options outstanding and exercisable:

	2006			2005		
	Number of Options		Average exercise price (Cdn$)	Number of Options		Average exercise price (Cdn$)
Balance, beginning of year	**425,000**	**$**	**9.57**	476,667	$	1.31
Granted	**550,000**		**27.98**	495,000		10.40
Exercised	**(143,333)**		**10.27**	(546,667)		3.12
Balance, end of year	**831,667**	**$**	**21.63**	425,000	$	9.57
Stock options exercisable, end of year	**350,002**	**$**	**18.89**	194,998	$	9.42

	Number of options		
Exercise prices (Cdn $)	**Outstanding**	**Exercisable**	**Remaining life (years)**
$ 2.88	20,000	20,000	0.85
$ 9.70	261,667	146,669	3.39
$ 16.60	15,000	5,000	4.48
$ 22.00 - $ 29.14	535,000	178,333	3.30
	831,667	350,002	3.29

(d) Conditional stock options and stock appreciation rights ("SAR"):

On December 14, 2006, 1,320,701 conditional stock options were granted to directors, officers, employees and consultants of the Corporation at an exercise price of Cdn $29.14 per share. Under the terms of the conditional stock options plan, options granted vest one third immediately and one third in each of the years following the date granted and have a life of five years. These options are conditional because the granting of these options has resulted in the number of Common Shares available to be issued under stock option plan exceeding the maximum number presently allowed under the Corporation's currently approved stock option plan. The conditional nature of these options can only be removed by ratification of the granting of the options by shareholders of the Corporation at the 2007 annual meeting and approval by the Toronto Stock Exchange. In the event that either the shareholders or Toronto Stock Exchange do not ratify the proposal with respect to these conditional options, all of the conditional options granted will immediately and automatically terminate without payment.

Concurrent with the granting of the options, the Board adopted a stock appreciation rights ("SAR") plan and granted 1,320,701 SARs to the directors, officers, employees and consultants who were granted conditional options. Upon the exercise of each SAR, the grantee will be entitled to receive a cash payment equal to the difference between the closing price of the Common Shares on the date immediately preceding the date of exercise, and the exercise price of Cdn $29.14 per SAR. In the event that shareholders and the Toronto Stock Exchange ratify the proposal with respect to the conditional options, all SARs granted will immediately and automatically terminate without payment and the options granted will remain in effect.

No compensation costs will be recognized with respect to either plan until the contingency relating to the ratification of the conditional stock options and potential cancellation of the SAR is resolved after which the grantees and the Corporation will have a mutual understanding of the ultimate award.

8. Share capital (continued):

(e) Normal course issuer bids:

On November 4, 2004, the Corporation renewed its normal course issuer bid to acquire up to 1,069,506 Common Shares on the open market until November 3, 2005. This was replaced by a normal course issuer bid program that commenced on November 4, 2005 and expired on November 3, 2006 and was not renewed. Pursuant to the Normal Course Issuer Bid the Corporation could have purchased up to 1,090,785 Common Shares. In 2005 the Corporation acquired 135,100 Common Shares at an average price of Cdn$7.85 per share for cancellation. No acquisitions under the normal course issuer bid were made in 2006.

(f) Per share amounts:

The following table summarizes the weighted average Common Shares used in calculating net earnings per share:

Weighted average common shares	2006	2005
Basic	**21,917,363**	21,650,215
Diluted	**22,095,507**	21,860,371

The reconciling item between basic and diluted weighted average number of Common Shares is the dilutive effect of stock options and convertible bonds. A total of 535,000 options (2005 – 150,000) and 3,333,333 of shares relating to the convertible bonds (2005 – nil) were excluded from the above calculation, as they were anti-dilutive.

(g) Stock based compensation:

The fair value of each stock option grant on the date of grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions and results. The fair value of stock options is amortized over the vesting period of the option.

Weighted average assumptions and results:	2006	2005
Risk free interest rate (%)	**4.13**	2.81
Volatility (%)	**42.99**	58.86
Dividend yield (%)	**–**	–
Expected life (in years)	**3.42**	3.80
Grant date fair value (Cdn $)	**8.80**	3.93

(h) Contributed surplus:

A reconciliation of contributed surplus is provided below:

		2006		2005
Balance, beginning of year	$	517,209	$	24,421
Stock-based compensation cost		2,423,945		625,365
Exercised		(407,622)		(132,577)
Balance, end of year	$	2,533,532	$	517,209

9. *Income taxes:*

Heritage Oil Corporation is subject to income taxes in Canada and Russia. All of the Corporation's operating activities are outside of Canada. Other than Canada and Russia, the statutory and effective tax rate in all jurisdictions is nil since activities in those jurisdictions are subject to production sharing agreements.

In Canada and Russia, the Corporation has available tax deductions of approximately $14,737,369 (2005 - $10,976) and tax losses of approximately $7,916,354 (2005 - $3,944,517), which expire from 2007 to 2026. At December 31, 2006, the future income tax liability of $2,346,605 (2005 - $2,346,605) is attributed to the tax effect, at a tax rate of 24%, of temporary differences related to property, plant and equipment in the Russian cost centre. A valuation allowance has been applied to fully offset the benefit of the Canadian tax deductions and Canadian and Russian tax losses.

10. *Financial instruments:*

(a) Fair value of financial assets and liabilities:

At December 31, 2006, the fair values of financial assets and liabilities are approximately equal to their carrying amounts due to the short maturities, as does the debt payable as the facility bears interest at market rates of interest.

The Corporation does not enter into derivative financial instruments for trading or speculative purposes.

(b) Credit concentration and risk:

All of the Corporation's production is derived from the Republic of Congo and Sultanate of Oman. In 2006 and 2005, the Corporation sold all of its production, at any point in time, in each country to a single customer for each commodity. Accordingly, substantially all of the Corporation's accounts receivables from petroleum and natural gas sales were from three customers.

Debtors of the Corporation are subject to internal credit review to minimize the risk of non-payment. The Corporation does not anticipate any default as it transacts with creditworthy counterparties.

(c) Foreign exchange risk:

The Corporation is exposed to foreign exchange fluctuations as it holds working capital and long-term debt in foreign currencies. There are no forward exchange rate contracts in place at, or subsequent to, December 31, 2006.

(d) Interest rate risk:

The Corporation is exposed to interest rate risks in respect of fixed rate convertible bonds and long-term debt.

11. *Related party transactions:*

In 2006, general and administrative expenses included an advisory fee of $1,494,317 (2005 - $877,686) charged by a director of the Corporation who was appointed CEO on October 6, 2006. In 2005 the Corporation established a management and finance office in Switzerland that required this director to relocate and he received a relocation allowance of $275,918.

12. *Segmented information:*

The Corporation operates in a single operating segment in the business of international exploration, development and production of petroleum and natural gas. The Corporation evaluates performance as a single entity. In 2006, the Corporation's petroleum and natural gas revenue and drilling rig revenue from continuing operations of $3,938,512 (2005 - $841,766) and $2,895,727 (2005 - $342,359) were derived from Oman and Uganda, respectively. At December 31, 2006 and 2005, the Corporation's property, plant and equipment by geographic area were as follows:

	2006	2005
	US$000	US$000
Uganda	$ 40,666	$ 26,992
Russia	22,243	9,778
Oman	10,141	4,349
Iraq	6,313	2,785
Democratic Republic of Congo	550	464
Pakistan	1,122	417
Other	17,277	16,268
	$ 98,312	$ 61,053

13. *Commitments and contingencies:*

Heritage's net share of outstanding contractual commitments at December 31, 2006 was estimated at:

	Total	Less than 1 year	1 - 3 years	4 - 5 years	After 5 years
	US$000	US$000	US$000	US$000	US$000
Long-term debt	$ 8,212	$ 147	$ 294	$ 294	$ 7,477
Convertible bonds	60,000	–	–	60,000	–
Operating leases	9,642	229	458	458	8,497
Work program obligations	16,750	10,000	4,875	1,875	–
Total contractual obligations	$ 94,604	$ 10,376	$ 5,627	$ 62,627	$ 15,974

The Corporation may have a potential residual obligation to satisfy the shortfall in officers' and former officers' secured real estate borrowings in the event of default, a shortfall on the proceeds from the disposal of the properties and the individuals being unable to repay the balance.

Convertible bonds were either converted into Common Shares or redeemed in 2007 (note 14).

On October 6, 2006, the Corporation terminated Mr. Micael Gulbenkian as its Chairman and Chief Executive Officer. Discussions are on-going with respect to the resolution of outstanding matters.

14. *Subsequent events:*

On January 17, 2007, the Corporation gave notice that it had exercised its option to redeem the 550 outstanding unsecured senior convertible bonds at 150% of par value for total proceeds of $82,500,000 plus accrued interest which was paid on March 28, 2007. 50 of the 600 unsecured convertible bonds, with a total par value of $5,000,000, were converted into 277,778 Common Shares at an exercise price of US$18.00 per share subsequent to December 31, 2006.

On February 16, 2007, the Corporation raised US$165,000,000 by completing the private placement of convertible bonds. The Corporation issued 1,650 unsecured senior convertible bonds, at par, which have a maturity of five years and one day and an annual coupon of 8.00%. The bonds are convertible into Common Shares at a price of US$47.00 per share. The Corporation may redeem, in whole or part, the bonds for cash at any time on or before February 16, 2008, at 150% of par value. Proceeds may be used to finance the redemption of the outstanding $55 million of convertible bonds at a premium of 150% referred to in the paragraph above and for general corporate funding purposes.

On March 9, 2007, the Corporation disposed of its 65% equity interests in Natural Pipelay Worldwide Limited ("NPWL") and Natural Technologies Limited ("Naturalay") to Grove Holdings Limited for consideration of 605,000 common shares in SeaDragon Offshore Limited ("SeaDragon"). SeaDragon, founded in 2006, is building one of the world's largest semi-submersible rigs. NPWL and Naturalay hold and market the technology relating to the buoyant drum lay system. The Corporation's CFO is a director of SeaDragon.

CORPORATE INFORMATION

BOARD OF DIRECTORS

MICHAEL HIBBERD*
Alberta, Canada

ANTHONY BUCKINGHAM
Switzerland

PAUL ATHERTON
Switzerland

WILLIAM KAUFMANN*
Alberta, Canada

JOHN MCLEOD*
Alberta, Canada

GREGORY TURNBULL
Alberta, Canada

*Members of the Audit Committee

OFFICERS

MICHAEL HIBBERD
Chairman

ANTHONY BUCKINGHAM
Chief Executive Officer

PAUL ATHERTON
Chief Financial Officer

SENIOR STAFF

ARMEN SAHAKIAN
VP Business Development

BRIAN SMITH
VP Exploration

STEPHEN KOBAK
VP Production Russia and CIS

PAUL LOGAN
Chief Geologist

STEVE CURD
Chief Geophysicist

ALASTAIR STUART
Chief Petroleum Engineer

JAMES BABAN
Country Manager, Iraqi Kurdistan

MARTIN ALIKER
President, Heritage Uganda

BRYAN WESTWOOD
General Manager, Heritage Uganda

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WIGGIN & CO.

Cheltenham, UK

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HERITAGE DRC LIMITED

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